

## NAFTA: The US Bite Won't Be As Bad As Its Bark

- A rapid series of talks at three-week intervals to renegotiate the North American Free Trade Agreement (NAFTA) is set to begin on 16 August, the earliest possible date permitted under US legislation, in pursuit of a US administration goal of concluding discussions by mid-December. The compressed timetable implies a hope of achieving a quick deal on points of common interest that can be held up as an achievement that contrasts with the US administration's delayed domestic agenda—rather than an all-or-nothing wholesale reworking of NAFTA.
- The US Trade Representative's (USTR) 17 July *Objectives* for NAFTA's renegotiation feature a mix of broad modernizations that overlap with Canadian and Mexican priorities; some specific updates and narrow technical requests; a few mutually inconsistent elements; and some extreme demands that go far beyond anything to which Canada or Mexico could agree. In the unlikely event that the USTR holds tight to the pursuit of its entire wish-list, NAFTA renegotiations are likely to be drawn out well into 2019, beyond both the July 2018 Mexican Presidential vote and the November 2018 US Congressional elections, with limited chances of conclusion.
- Over the next few months, it would be prudent to look through any major ups and downs during the coming talks in anticipation of an eventual accord on a revised NAFTA whose essential elements will remain intact. NAFTA is getting tweaked, not ripped up: the US administration's bite won't be as bad as its bark.

### US NAFTA DEMANDS: IN CONTEXT, LESS THAN MEETS THE EYE

US Trade Representative (USTR) Lighthizer released the US administration's formal [Summary of Objectives for the NAFTA Renegotiation](#) on 17 July, the required 30 days ahead of the end of the three-month consultation period currently underway between the US administration and the White House. This consultation has followed the [18 May notice](#) of the Trump Presidency's intent to renegotiate the North American Free Trade Agreement (NAFTA). On 19 July, the USTR's office announced, after liaising with the Canadian and Mexican governments, that formal renegotiations of NAFTA would begin at the end of the consultations on 16 August, the first possible day allowed under US law.

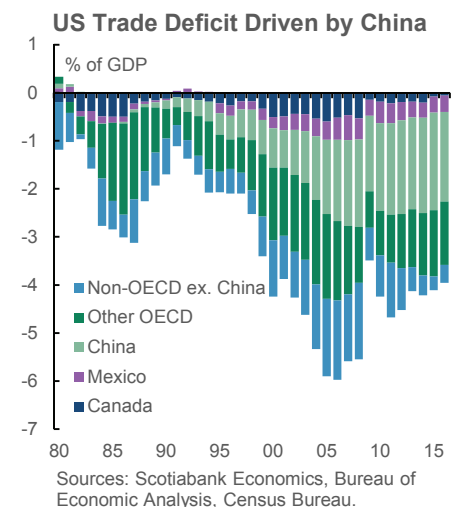
The US *Objectives* are a mixed bag of over 100 points ranging from large *meta* issues to technical *minutiae*. On a superficial level, the *Objectives* read as an aggressive agenda to rewrite NAFTA in favour of the US. Taken in context, however, the USTR's aims look much more modest: large sections of them simply replicate many of the principles mandated for all international trade negotiations by Congress in the [Bipartisan Congressional Trade Priorities and Accountability Act of 2015](#) that provided Trade Promotion Authority (TPA) for the Trans-Pacific Partnership (TPP). Other elements—a mix of modest aims and deal-breaking over-reach—echo the March 2017 draft letter to Congress from then-acting USTR Stephen Vaughn that outlined some of the Trump Administration's interests in re-opening NAFTA. By many accounts, that wide-

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Chart 1



ranging draft prompted a push-back by Congressional members eager to assert the legislature's prerogatives on matters of international trade. This reaction led to the far more deferential 18 May letter from USTR Lighthizer to Congress to trigger US preparations for NAFTA talks. Congress has made it clear that it will not play a passive role in re-opening NAFTA and the Trump Administration has listened.

An assertive US Congress that is far more engaged than when the Canada-US Free Trade Agreement (CUSFTA) and NAFTA were first negotiated over 20 years ago is broadly good for NAFTA's future. During the last six months, Canada's officials have made a concerted and well-publicized effort to lobby US Senators and Congressional Representatives, State Governors and legislators, and municipal politicians whose constituents benefit from North American trade to stand up for NAFTA—creating what the *New York Times* called a “doughnut around a White House-shaped hole” in support of the agreement. Pressure from all of these officials should keep the US administration in check as talks move forward.

To wit, in May, 18 key Republican Senators wrote a [letter to USTR Lighthizer](#) to indicate that, while they believe NAFTA would “benefit from strengthening and modernization,” any “efforts to abandon the agreement or impose unnecessary restrictions on trade with our North American partners will have devastating consequences.” All 32 first-term Republican Congressional Representatives followed up with [another letter to USTR Lighthizer](#) in July that recognized that “a 23-year-old agreement needs updating”, but cautioned, “We are also keenly aware of the potential for damage to US farmers, business, manufacturers, services providers and workers if longstanding agreements are suddenly vacated.” The Representatives went on to reiterate one of Canada's key NAFTA talking points: “Canada and Mexico are our largest export markets, and our USD 3.5 billion in daily trade with these two countries supports 14 million American jobs.” With Congress figuratively at the NAFTA negotiating table, the core elements of the agreement should be secure.

Since the publication of the US *Objectives*, Mexico's Secretary of the Economy Ildefonso Guajardo has reversed his [long-standing position](#) that “negotiation strategies are not shared” and released on 1 August to the Mexican Senate his own 21-point take on Mexico's [priorities for talks on NAFTA](#) following six months of public consultations. Guajardo's list reiterates Mexican President Peña Nieto's key [objectives](#) for the modernization of NAFTA in the areas of telecommunications, energy, and e-commerce, and adds labour mobility, environmental protection, and intellectual property concerns to the top of Mexico's list. The remainder of Guajardo's 21 points overlap with elements in the US *Objectives*, most notably a call to modernize NAFTA's dispute-settlement mechanisms, while also calling for a guaranteed access for Mexican companies to government procurement processes in the US and Canada.

Canada's government has so far remained disciplined in resisting calls for it to lay out its bargaining stance, but on Monday, 14 August Foreign Minister Chrystia Freeland will appear before the Canadian House of Commons' [Standing Committee on International Trade](#) to discuss Canada's NAFTA priorities. Beyond noting a goal of reaching agreement on a good deal for North America, Minister Freeland has not articulated other key negotiating points. This approach has kept Canada out of the Twitter crosshairs while retaining substantial optionality to adjust the Canadian government's stance as the talks develop, with support from the cross-party [NAFTA Council](#) that the Minister named on 1 August.

The remainder of this paper parses the US *Objectives* to identify the elements that will likely occupy negotiators over the next four months of talks and could form the foundation for an accord on modernizing NAFTA. Negotiations will likely be focused on issues that overlap with Canadian and Mexican priorities in order to make quick progress. We also examine a few narrow, technical US requests that may feature in the eventual renewal of NAFTA or act a bargaining chips in negotiations. Finally, we dismiss the obviously extreme and internally inconsistent elements of the *Objectives* on which it would be impossible to find a consensus amongst the three NAFTA parties.

As the beginning of negotiations looms next Wednesday, this analysis leaves us anticipating—as we did in May—some eventual ‘tweaks’ to NAFTA in the coming months rather than a wholesale reworking of North America's cornerstone trade agreement. As has been the case in several other policy realms, the US administration's bite on NAFTA likely won't be as bad as its bark.

## AREAS OF COMMON GROUND

There are a number of issues on which there is already a broad consensus amongst Canada, the US, and Mexico regarding potentially useful updates and additions that could be made to the existing NAFTA framework. These include:

- Improved anti-corruption measures that raise regulatory standards, transparency, accountability, and enforcement mechanisms in corporate and public-sector governance across North America;
- Efforts to increase regulatory harmonization and reduce unnecessary differences across all three NAFTA countries with a view to reducing the costs of compliance;
- Streamlining of customs procedures and reducing documentation to make trans-border movements of goods and services simpler, quicker, and less costly, especially for small business;
- Enhancement of labour protections and environmental standards, plus the full incorporation of existing side agreements on these issues in the main body of NAFTA. These matters were already considered and largely resolved under the TPP negotiations;
- Greater liberalization of e-commerce and digital services, music, and media trade through the inclusion of substantive new sections in the NAFTA text, reflecting in part the fact that some of these areas of activity didn't exist when NAFTA came into force during the mid-1990s; and
- Protocols on the operations of state-owned enterprises (SOEs) to ensure that they do not engage in anti-competitive practices that inhibit trade in goods and services between NAFTA countries.

An early and sustained focus of the talks on these issues will likely be a sign that the US administration is prioritizing achievement of an agreement on changes to NAFTA by end-2017 rather than the narrow pursuit of its self-interest.

There are a few other areas where there is broad agreement that NAFTA would benefit from updates and enhancements, but it's not obvious that an immediate consensus will be reached on how this should be done. All three NAFTA member countries cite the need to expand and improve NAFTA's provisions on intellectual property, but on specific goods, services, or sectors, they have different views on what this would mean. On new drugs, for instance, the US is keen to institutionalize stronger patent protections, while Canada and Mexico will steadfastly work to preserve their generic drug industries. Similarly, the US and Mexico have both raised telecommunications, financial services, and the energy sector as areas for discussion on greater market access across North America for their businesses, but all three countries have very different views on how progress in these areas should look.

## TECHNICAL POINTS AND POSSIBLE BARGAINING CHIPS

There is an additional set of negotiating points in the USTR *Objectives* that are relatively focused, specific, and technical that range from what appear to reflect very specific requests from industry lobbies, to the individual obsessions of West Wing policymakers, and onward to reasonable, if narrow, points on which NAFTA could be updated or used as a precedent-setting platform for other trade agreements. Some of these points have limited practical implications for Canada and Mexico, and could be used as concessions in the pursuit of other NAFTA priorities.

For instance, the USTR *Objectives* note that some countries artificially keep the value of their currencies low in order to boost the competitiveness of their exports, and that NAFTA must be revised to prevent this. Taken at face value, this sounds ominous, but Canada and Mexico have never been found to manipulate their currencies in independent evaluations by the International Monetary Fund (IMF) nor in the US Treasury's own assessment. The USTR's stated desire to include anti-currency-manipulation clauses in a revised NAFTA seems to be solely an effort to create standard clause for other trade agreements with non-NAFTA countries. Canada and Mexico could agree to this in exchange for their own requests on other parts of the agreement.

Similarly, the USTR *Objectives* call for an end to regulatory requirements that force financial sector institutions to maintain proprietary data which is subject to government oversight on local, accessible servers. While most financial institutions broadly

support the flexibility and lower costs that this change would likely provide, it's not at all clear that this has been a longstanding concern or irritant for them. Again, this may be a US demand that can be satisfied in order to protect more essential items elsewhere in NAFTA.

All three NAFTA countries appear interested in easing the temporary flow of professional and executive workers throughout North America, but they disagree on the details of how this should be achieved through new visa programs. The differences between their positions are small, and technical progress on closing these gaps may breed goodwill for larger, more difficult negotiating points.

Finally, recent press has focused on the USTR demand that Canada raise its duty-free allowance for cross-border online shopping as a potential difficult flashpoint in negotiations. At present, the US provides a USD 800 exemption, Mexico provides a roughly USD 300 exemption, and Canada's duty-free ceiling on cross-border e-commerce is set at much lower CAD 20—amongst the lowest thresholds of any industrialized country. Canadians already have access to a CAD 800 exemption if they physically cross the border for at least 48 hours. The possibility of raising the exemption was dismissed by Minister Morneau early in 2017, but we expect that this will be revisited if it can be traded-off for concessions elsewhere.

### **SURPRISING OMISSIONS OR SIMPLY UNUSUAL SUBTLETY?**

There are some surprising omissions from the USTR's *Objectives* with respect to longstanding irritants in North American trade relations. Their absence may imply a softer approach to NAFTA negotiations than the rhetoric of the *Objectives* suggests—or simply that these points will be pursued by more oblique means.

No explicit mention is made of Canada's supply-management systems in dairy, poultry, and egg production, which may be due to NAFTA's treatment of agriculture under bilateral side agreements rather than in the main body of the text. Nevertheless, the US *Objectives* do articulate a desire to remove non-tariff barriers to US agricultural exports, including discriminatory measures, restrictive administration of tariff-rate quotas, and other limits on market access such as cross-subsidization, price discrimination, and price undercutting. Elimination of these limits would address the US dairy industry's frustration with the Canadian treatment of ultra-filtered milk, an issue that President Trump raised in April.

US frustrations with Canadian and Mexican generic drug manufacturers undercutting US name-brand prices don't receive an explicit call-out in the US *Objectives* either, but as noted above, any work to beef-up NAFTA's intellectual property provisions will inevitably address this issue.

The US *Objectives* stay similarly silent on the longstanding softwood lumber dispute between the US and Canada. Like agriculture, softwood lumber is handled under bilateral processes outside of NAFTA and the USTR did not use the NAFTA *Objectives* to ratchet up the tone of that contentious discussion.

### **LINES THAT WON'T BE CROSSED**

The US *Objectives* do raise a number of additional issues on which it would likely be difficult to reach an agreement with Canada and Mexico to amend NAFTA.

From a foundational perspective, neither Canada nor Mexico can agree with the USTR's overriding goal of reducing US trade deficits. As chart 1 shows, trade with China accounts for about 60% of the total global US trade deficit, trade with Europe covers about 21% of the deficit, and only about 7% of the deficit comes from trade with Canada and Mexico. Abstracting from energy and energy-related resource flows, the US runs a trade surplus in both goods and services with Canada. Substantial reductions in the US trade deficit can't be achieved through changes in the trade policy framework with Canada and Mexico. Moreover, so long as the US dollar remains the global reserve currency, the US Treasury market maintains its role as a major haven from global risk, and the US as a whole spends more than it earns, the US will continue to run a surplus on its international capital account that has to be matched by a trade deficit in its international current account.

Nevertheless, the USTR's *Objectives* raise the possibility of revising NAFTA's rules on the minimum amount of North American content goods must have in order to move throughout North America on a duty-free basis. NAFTA's current rules of origin put this

minimum local threshold at 62.5% of total content for autos and 60% for all other goods. On average, North American auto production easily exceeds this minimum and there could be room to raise it further without disrupting existing supply chains, though such a move would likely reduce the global competitiveness of North American vehicle production. It would be nearly impossible, though, for Canada and Mexico to agree to a further modification of NAFTA's rules of origin that specifies a minimum contribution of US content: rather than advancing free trade, such a move would put NAFTA on an increasingly mercantilist footing.

The most toxic proposal in the USTR's *Objectives* concerns the suggestion to do away with NAFTA's Chapter 19, which spells out the mechanisms by which disputes with respect to goods and services trade are resolved. Despite repeated calls throughout the *Objectives* for a means to increase market access for US exports, this proposal goes in the opposite direction. Chapter 19's expert tribunals provide neutral reviews and prescribe remedies in cases of alleged dumping, unfair subsidies, or other nontariff barriers that go against the letter and spirit of the level playing field NAFTA seeks to create. This dispute-settlement mechanism was the key reason that Canada entered into discussions on the CUSFTA and it is the most essential element of NAFTA for both Canada and Mexico. Chapter 19's processes could be improved through standing rosters of experts to participate on its tribunals, but Chapter 19 cannot be wholesale trashed. Without some version of Chapter 19, there is no NAFTA for either Canada or Mexico.

Canada and Mexico are also adamant that they need to maintain their existing exclusion under NAFTA from temporary 'safeguard' tariffs that the US imposes on surges of imports of specific goods from other countries. The USTR *Objectives* propose an end to this exclusion, which would hurt exporters from both countries in the event of a US trade dispute with non-NAFTA countries. Ending this exclusion is antithetical to the rules-based certainties under NAFTA that concessions in other areas are meant to provide.

Finally, the US government's negotiating *Objectives* include several references to a desire to make public procurement process at all levels of government in the US more exclusively the domain of US suppliers under 'Buy American' rules—even as Canadian and Mexican government purchasing programs are increasingly open to firms of any nationality. Naturally, this movement toward less rather than more reciprocity under NAFTA would be politically and practically difficult for Canadian and Mexican negotiators to accept when the USTR *Objectives* themselves call for "Fair, transparent, predictable, and non-discriminatory rules to govern government procurement in the NAFTA countries."

## THE US DOESN'T HAVE A MONOPOLY ON BARGAINING POWER

There is a presumption that all of the leverage in the forthcoming NAFTA negotiations resides with the US, owing to the size of its economy and the fact that more than three-quarters of both Canada's and Mexico's trade is tied to the American market. This likely overstates Washington's bargaining power with its NAFTA partners, in part because it ignores the concentrated importance of trade with Mexico and Canada in specific US sectors and border States. It also ignores the extent to which Canada and Mexico have taken steps to diversify their trade with the rest of the world through their participation in bilateral, regional, and plurilateral trade agreements. By some measures, both countries stand to benefit as much or more from an 11-member TPP without the US as they would with the US involved.

Clearly, a major disruption in the NAFTA framework would have negative effects on Canada and Mexico and cast a pall over growth and investment in both countries for some time, but a suspension or permanent end to US participation in NAFTA wouldn't signal an end to North American trade given

Table 1

### WTO Most Favoured Nation Tariff Schedules, 2015

	Canada	US	Mexico
<b>Total</b>			
Simple avg. MFN tariff level (%)	4.2	3.5	7.1
Trade-weighted avg. MFN tariff (%)	3.2	2.2	4.7
<b>Agricultural products</b>			
MFN tariff level (%)	16.7	5.2	15.6
Trade-weighted avg. MFN tariff (%)	13.5	3.8	23.6
<b>Non-agricultural products</b>			
MFN tariff level (%)	2.2	3.2	5.7
Trade-weighted avg. MFN tariff (%)	2.2	2.1	3.3

Sources: Scotiabank Economics, WTO. Trade-weighted data from 2014.

the established supply chains and commercial relationships that have been built. NAFTA's terms would continue to cover the small volumes of trade between Canada and Mexico following a US withdrawal. Trade between the US and Canada could eventually revert to the terms of the preceding CUSFTA, but this wouldn't be immediate or automatic: Congress would likely have to pass some enabling legislation for CUSFTA to come back into effect. In the meantime, trade with the US for both Canada and Mexico would likely revert to the Most-Favoured Nation (MFN) basis, with the average tariff rates outlined in table 1—so long as the US remains in the World Trade Organization (WTO). While President Trump has mused about leaving the WTO, this isn't really a credible threat since it could severely disrupt US trade relations with the entire world and even cause a credit event on outstanding US Treasuries and US corporate debt as WTO withdrawal would represent a material change in circumstances under conventional bond contracts.

Under MFN tariffs, goods would enter the US from Canada and Mexico with lower average tariffs assessed than US goods would incur heading into either of the other two NAFTA countries. A slice of intra-North American trade already takes place under MFN provisions in cases where the process of qualifying goods for tariff-free movement under NAFTA's rules of origin is more costly than the additional reduction in applicable tariffs is worth. Hence, there is a clear precedent for trade continuing in this fashion.

In brief, both Canada and Mexico could walk away from these NAFTA talks if they are presented with an untenable set of demands by the USTR. In contrast, it's notable that neither the US *Objectives* nor the White House has repeated President Trump's aggressive musing earlier this year about having at the ready a signed executive order that, if invoked in the face of difficult negotiations, would begin immediately the process of pulling the US out of NAFTA. This likely reflects the strong opposition such a move would encounter from Congress and other levels of government.

#### **LOOK THROUGH THE UNCERTAINTY OF THE MONTHS AHEAD**

The next few months will likely be marked by a good deal of hand-wringing about the future of NAFTA that is unlikely to reflect the eventual content of a deal to renegotiate the trade accord.

The US has requested a very ambitious timetable for the talks on renegotiating the agreement: seven rounds of meetings with three-week breaks in between them, with a view to concluding the negotiations by mid-December. It's not clear that the US administration has made adequate staff appointments to keep up with this pace. Progress at this clip requires a team that can respond to developments in each round, formulate alternative bargaining positions, and come back after each break ready to move the discussions forward. If this proves impossible, either the agenda will need to be scaled back in order to meet the end-2017 target to conclude the talks, or the discussions will drag well past the 2018 Mexican Presidential elections and 2018 US midterms, and into 2019. Either result would likely portend a much less substantial reworking of the NAFTA than a comprehensive realization of the USTR's negotiating *Objectives* would imply.

With this context in mind, it would be prudent to look through major ups and downs during the coming talks in and instead look forward in anticipation of an eventual accord on a revised NAFTA whose essential elements remain intact. NAFTA is getting tweaked, not ripped up.

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