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The Potential Effects of Renegotiation of NAFTA

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In the U.S. presidential campaign, Donald Trump criticised NAFTA, calling it the "worst trade deal" the U.S. has ever signed. He decried the agreement as contributing to the high U.S. trade deficit with Mexico and loss of jobs to that country. In the first days of his presidency, Trump said his administration would renegotiate NAFTA to make it more beneficial to the U.S. Talks on this issue could take a while. Moreover, if the partners remain inflexible in their demands, withdrawal from NAFTA cannot be excluded. Its renegotiation may also have a negative impact on the world economy, partly by increasing uncertainty and limiting investment in NAFTA member states.

Assessment of NAFTA. The idea to create the North American Free Trade Agreement (NAFTA), composed of the United States, Canada and Mexico, was controversial from the beginning. The agreement entered into force in 1994 and gradually eliminated all customs tariffs and most non-tariff barriers. NAFTA opponents argue that it contributes to the loss of jobs to Mexico where labour costs are lower, while supporters claim that the U.S. benefits from easier access to foreign markets and lower prices of goods, which underpin consumption, economic growth and job creation in the U.S. In the recent presidential campaign, then-candidate Donald Trump sided with NAFTA's critics and has since made NAFTA renegotiation one of his top promises regarding trade.

After more than 20 years, the economic results of NAFTA are hard to assess. That is because economic relations between its member states have been affected by a variety of factors, such as the global financial crisis and fluctuating exchange rates. From the perspective of Mexico and Canada, NAFTA is usually perceived as positive because it contributes to job creation and increased productivity (in Mexico) and enhanced international competitiveness (Canada). For the U.S., NAFTA's influence on the economy, including growth and number of jobs, is moderate. This is due in part to the relatively modest level of trade with Canada and Mexico, equal to around 7% of U.S. GDP. However, it is worth noting that under NAFTA, U.S. trade (including services) with Canada and Mexico (respectively, America's first- and third-largest trade partners) has risen fourfold, from about $300 billion in 1993 to about $1.2 trillion in 2015. Concurrently, the U.S. deficit in trade in goods with both partners has significantly risen, for example, to almost $60 billion with Mexico in 2015. Moreover, because of NAFTA, the U.S. economy is highly interdependent on both partners through various supply chains. It is estimated that 40% of imports from Mexico and 25% of imports from Canada are components for American firms (in trade with China, it is around 4%). This is the result of increased U.S. investment in those countries. In 1993-2014 in Mexico alone, investment increased almost sevenfold, from $15 billion to $101 billion, including in the automotive and textile industries. These changes have affected the U.S. labour market. Estimates vary but it is widely assumed that around 200,000 manufacturing jobs in in the U.S. have been lost. Given that the manufacturing share of non-farm employment in the U.S. has decreased by about 22 p.p. (from around 30% to just over 8%) since the second half of the 20th century, NAFTA is responsible for only 0.14 p.p. of that change. It is also worth noting that increased competition has contributed to higher pressure to check wages in U.S. manufacturing.

Potential Negotiation Strategies. In keeping with his campaign promises, President Trump announced in his first few days in office the prompt start of talks with the leaders of Canada and Mexico on changes to the trade agreement (based on Art. 2202 NAFTA). However, no specific U.S. goals have been stipulated beyond a general effort to "bring back" jobs to the country.

In the negotiations, Trump's administration will likely focus on U.S. relations with Mexico. In this context, it probably will use as leverage threats to re-impose tariffs (of up to 35%) or an import tax called a border adjustment tax (of up to 20%) on goods coming from Mexico. According to the NAFTA Implementation Act of 1993, the U.S. president has the right to impose taxes on NAFTA countries to "maintain the general level of reciprocal and mutually advantageous concessions" (Sec. 201). The decision can be based simply on "consultations" with Congress, for example, with a selected committee. These provisions can be interpreted very widely. Probably any meeting of administration representatives and members of Congress would suffice. An example of disruption of "mutually advantageous concessions" could be the VAT rate in Mexico, since the U.S. does not have that same tax system.

The U.S. president has the power to impose tariffs without permission or consultations with Congress based on other laws, for instance, the Trade Expansion Act of 1962. It provides the right to impose tariffs or quotas to offset an adverse impact on national security from imports. Moreover, the Trade Act of 1974 enables the use of similar tools when a foreign country denies the U.S. its FTA rights, among other perceived threats. These provisions also can be interpreted quite widely. Congress could try to block Trump's actions by changing the laws that give him the authority to impose the tariffs (to override the presumed presidential veto it would need a two-thirds majority in both chambers). More important, though, is that Congress probably must consent to any changes made to NAFTA.

Trump has threatened to withdraw the U.S. from NAFTA and can do so without Congress' consent. Using Art. 2205 NAFTA, the U.S. can withdraw from the deal with six months' written notice to the other parties. This threat should be treated as U.S. leverage to force its partners to agree to renegotiate the agreement. If it followed through with tariffs or withdrawal, though, the U.S. probably would be sued by companies hurt by those decisions.

In any renegotiation of NAFTA, Mexico likely would strive to connect the talks on trade to other topics, such as immigration, including keeping the flow of migrants from Central American states, and security, particularly cooperation fighting drug gangs. A threat from Mexico to reduce its actions in these areas could strengthen its position in the negotiations with the U.S.

Mexico President Enrique Peña Nieto's recent decision to cancel a planned visit to Washington because of the changes in U.S. immigration policy, including Trump's executive order to begin building a wall on the U.S.-Mexico border, may be seen as Mexico's willingness to adopt an assertive stance in negotiations with the U.S.

Potential Effects. The NAFTA renegotiation process would have its own dynamics and the effects are difficult to predict. According to Trump's statements, the U.S. would like to build up jobs by partially protecting its own market. In turn, Canada and Mexico probably will strongly defend access to the U.S. market. This contrast could make agreement harder to achieve and prolong the negotiations. In this case, there would be added uncertainty concerning the final rules and investment in the NAFTA countries could be limited as businesses wait to see how to react to the changes. That can negatively affect the countries' economic growth and positive sentiment from international markets. The introduction of U.S. tariffs and taxes on imports from Mexico probably would incline the latter to increase trade barriers, in turn affecting U.S. exports (about 6 million jobs in the United States depend on trade with Mexico). Imposing taxes also could result in higher prices for many goods in the U.S., possibly leading to inflation and providing an additional argument for the Federal Reserve to increase interest rates. Higher yields on U.S. bonds implies an inflow of money to the country, mainly away from emerging markets (including Poland), and thus increase the value of the U.S. dollar, in turn making American exporters less competitive in relation to European companies, for example.

If the negotiating positions remain inflexible not only on trade but also on other aspects of relations between the partners (such as immigration), a failure of the talks cannot be excluded. The U.S. probably would withdraw from NAFTA in that case, and U.S.-Canada trade relations would return to the bilateral trade agreement from 1989. U.S. trade with Mexico would probably hinge on WTO rules (Canada and Mexico could maintain the NAFTA provisions for each other). Therefore, according to the most-favoured-nation rule, the average U.S. tariff on goods from Mexico should be the same as for other states, which is 3.5% on average (exact tariff depending on the sector). Tariffs exceeding this rule could be disputed by Mexico in the WTO.

It is difficult to determine what impact new trade barriers could have on restoring jobs in the U.S. It is possible that U.S. companies would continue to outsource production to countries with lower labour costs (such as to South Asia) to retain international competitiveness. However, pressure from the Trump administration on some U.S. companies, including Ford and General Motors, has led them to announce a halt on new investment in Mexico and the development of factories in the U.S. However, in the long term, a deterioration in trade and investment relations with the U.S. likely would negatively affect Mexico's economy (around 80% of Mexican exports go to the U.S.). Lower living standards in Mexico could increase immigration pressure on the United States, making it more difficult for the U.S. administration to control its borders.