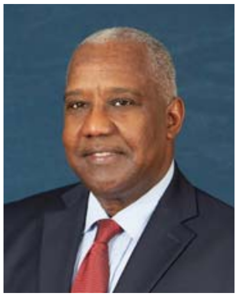

Special Report:
By Byron Shoulton
FCIA Chief
International
Economist

NORTH AMERICAN FREE TRADE AGREEMENT
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The U.S. Administration considers the existing North American Free Trade Agreement [NAFTA] a terrible deal which has hurt U.S. interests, cost the U.S. thousands of jobs, while contributing to the decline of important industries in the U.S. The Administration has indicated that the U.S. economy will be better off if it were to walk away from the Agreement in its present form. President Trump has made clear his intention to withdraw from NAFTA if current talks between the U.S., Canada and Mexico fail to produce a new and improved trade pact that would be more advantageous to the U.S. Under NAFTA, a continent-wide web of supply chains and interconnections link all three countries via bustling trade flows that closely rely on the production processes of several industries to satisfy the supply of various raw materials, spare parts, intermediate goods and services.

A number of surveys aimed at measuring the impact on all three economies - should NAFTA be scrapped - predicts the move would rattle financial markets, prompt a decline in U.S. Treasury yields and would likely wipe half a percentage point off U.S. GDP growth in 2019. Researchers have concluded that with the U.S. out of the 24-year-old trade pact, the S&P 500 stock index would fall by approximately 5% as investors seek safer heavens. Also, withdrawal from NAFTA would be expected to spike U.S. inflation, hobble consumer spending, push the Federal Reserve to cut interest rates and would likely fuel fresh U.S. unemployment. Above all, blocked imports, higher prices and broken supply chains would harm U.S. economic potential over the medium-long term.

125 Park Ave, 14th Floor, New York, 10017 * Tel: 212-885-1500 * Fax: 212-885-1535 * www.FCIA.com

Certain U.S. industries (autos and their spare parts, light manufacturing, agriculture, trucking, agro-business, food processing, telecommunications, electronics assembly, et.al), would experience disruptions in their reliance on the current supply chain arrangements, that were put in place in the 24 years since NAFTA was enacted.

The good news: these trends would likely not last a long time. According to researchers the short-term downturn in the U.S. would be sharp while the longer-term impact on the economy would likely be mild. The reason: trade represents approximately one-third of total U.S. GDP. In Mexico, however, where trade represents almost 80% of GDP, the economy would be deeply affected and suffer the most. According to one estimate a pullout by the U.S. would trigger a decline of around 1% in Mexican GDP growth during the first year and by a further 2% by year three. The Mexican peso would weaken by 8%-9%, its stock market would fall by up to 10% and the economy would likely shrink by 2% by 2022. Mexican inflation would add an estimated 3 points, rising to 11% in 2019.

The Canadian economy is projected to lose half a point in GDP growth in 2019 if NAFTA was scrapped; the Canadian dollar would weaken by an estimated 3-4% and the Canadian stock market would lose an estimated 6% initially. However, by 2022 studies show that the impact on Canadian growth would have diminished.

The consensus view is that pulling out of NAFTA will have only a scant impact on the U.S. trade deficit, the primary reason given by the Administration for wanting to withdraw. Leaving NAFTA would modestly trim the U.S. trade deficit. The reduction in imports would be largely offset by a concurrent loss in exports. Given those projections, it's worth asking: would it have been worthwhile to the U.S. to take the drastic step of withdrawing from the NAFTA trade agreement as is being recommended by some?

In the absence of NAFTA, global trade would be governed by World Trade Organization [WTO] rules, which still leaves the Administration's goal of reducing the U.S. trade deficit out of reach. According to private

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estimates the U.S. trade gap would remain at an estimated 3.2% of GDP in 2019 and 2020 compared with a modest widening to 3.3% of GDP in 2019, if the U.S. remained in NAFTA.

Membership in the WTO means foregoing the option of squeezing foreign rivals with trade restrictions. In return the WTO provides secure access to foreign markets along with specific remedies should one country (or industry) feel they are a victim of dodgy trade practices. Among these remedies is the option of imposing new tariffs if a country or industry find itself facing surging imports that are subsidized or being sold below cost. Defensive tariffs today apply to three-fifths of American steel imports. That's before the imposition of the new tariffs announced by President Trump in March 2018.

Negotiations between the three NAFTA trading partners have been crawling along without significant progress. Negotiators met for the eighth round of talks in Montreal, Canada in March 2018. The stakes were high as the U.S. simultaneously imposed high tariffs on all imports of steel and aluminum of 25% and 10%, respectively just as the round of talks begun. As a gesture to both Canada and Mexico the U.S. at the last minute granted both countries a temporary exemption from the new tariffs, provided that all three countries can arrive at a timely and "fair" agreement in the ongoing NAFTA talks. In 2016 Canada sold 88% of its steel exports to the U.S. Mexico sold the U.S. 73% of its steel exports. By the same token Canada imported more than 50% of all U.S. steel exports. Canada is also the largest supplier of aluminum to the U.S.

Presumably a new NAFTA agreement that would be deemed "fair" would accommodate the varied demands by the U.S. including opening up the Canadian and Mexican markets to more U.S. exports. President Trump asserted that the U.S. would be a little bit "flexible" in its recent negotiations while stressing that there will be "no rush" toward reaching a deal. This suggests that delays toward arriving at a new agreement should not be ruled out. However, upcoming Mexican presidential elections due in July 2018, adds some complexity to the ongoing NAFTA talks. For example, will an incoming administration in

Mexico be expected to ratify and abide by the terms of a new agreement? Or, will a new Mexican government assuming office in January 2019 want to negotiate and sign-off on its own NAFTA Agreement?

The leading candidate in Mexico's Presidential campaign, Manuel Lopez Obrador [AMLO], has warned that negotiations shouldn't be concluded before July's election. AMLO named a former World Bank economist who once represented Mexico at the World Trade Organization, to lead the country's negotiating team should he win the election. In theory, a newly elected AMLO government would be tougher to negotiate with that the current lame duck and unpopular administration of President Pena Nieto.

Canada's changing role in the North American supply chain helps clarify what is at stake for it in the current negotiations. Canada's role changed significantly – and for the worse- when its cost structure began to rise rapidly after 2002 as the Canadian dollar returned to parity with the U.S. dollar and the Canadian government raised labor and energy costs while it increased environmental regulations. Producers in low-wage consumer goods industries such as clothing and furniture moved abroad. What remained in Canada's manufacturing sector were resource-based industries and surviving assets in the auto industry, both of which pay high wages.

Mexican associations of automobiles and auto parts manufacturers together with the government of Mexico have put forward proposals on rules of origin for the auto sector, which were presented to the NAFTA negotiators in Montreal last month. Mexico's chief negotiator at the talks has ruled out accepting the U.S. position of bringing to 85% the regional content requirement for free trade in the automotive sector. Instead, Mexico is proposing working with companies in the sector to see what the requirements for components should be in the future for the industry. This is cited as one of the critical issues in the negotiations of the trilateral agreement.

What's behind the U.S. trade deficits?

The willingness or ability of other countries to sell more of their goods

to the U.S. than the U.S. is able to sell in those countries says simply that over the past four decades Americans have been able to consume more than they produce. It also means that the U.S. owes money to the rest of the world, in the form of low-yield bonds. The rest of the world like holding these bonds, and the U.S. is able to finance its deficits.

Why does President Trump believe that the trade deficit can be fixed by imposing tariffs? Studies show that while tariffs reduce trade, they do not reliably increase the tariff-raising country's trade balance. In part this is because when imports fall, foreigners will get fewer dollars, and the dollar will gain value through scarcity. A strong dollar makes U.S. goods more expensive and thus less appealing, so exports will fall just as imports do. As a result, deficits persist.

An overwhelming majority of forecasters agree that withdrawing from the trilateral NAFTA trade pact would leave U.S. economic growth weaker over both the short and longer-terms. Indeed all three nations would be worse off and so would the integration of global production and manufacturing processes across borders. For example, new tariffs on imported steel and aluminum would also make manufacturing in the U.S. more expensive while making Canada and Mexico more attractive destinations for capital. If the recent tariffs had been applicable to Canada and Mexico, the Canadians were prepared to respond in kind. Mexico's likely response was not made clear. Nonetheless, the move would have raised the odds that the next big steel fabricating plant built in North America wouldn't be in the U.S.

Countries not exempt from the steel and aluminum tariffs, including the European Union, Japan, and China have all indicated that counter measures to the U.S. action are being contemplated. This means that the world may be looking at a series of tit-for-tat trade tariffs going forward, with the upshot being higher prices to consumers, a build-up of distrust between countries and heightened trade tensions taking root across the globe.

Meanwhile, just over 50% of all Americans believe free-trade as exemplified by NAFTA is a good thing. The prevailing economic theory of the

past several decades favored international trade, believing it brings overall benefits even if some workers and industries are hurt over time. The questions being raised by team Trump seek to revise that theory and to once again advance the thinking that barriers to trade in favor of protectionism are often in the best interest of nation states. The latest bet on whether or not President Trump will pull the U.S. out of NAFTA stood at 30%, up from 26% in November 2017.

Negotiators from all three countries are signaling progress on auto-industry issues that are some of the thorniest in the talks to overhaul NAFTA. All agree that the rules of origin for the auto sector need to be changed since the current rules are no longer sustainable. The U.S. wants to have light vehicles contain 50% U.S. content to cross U.S. borders duty-free. This would presumably draw more manufacturing jobs back to the U.S. However, it appears Canada wants similar treatment since its manufacturing sector has lost capacity to lower-cost jurisdictions such as Mexico. U.S. negotiators appear less strident in recent statements, suggesting positions are converging on some aspects of a new deal. Canadian negotiators are admitting that some of the more recent U.S. proposals to broaden the definition of what could be counted toward U.S. content (including software, technological components and raw materials like steel) are "interesting" and "creative" ideas. Senior Mexican officials make mention of a more compromising tone emerging from recent talks held in March 2018.

Without saying so, the U.S. at times appear keen in wanting to conclude a new NAFTA agreement [possibly by May 2018]. If not, talks would have to be extended into 2019 after Presidential elections are held in Mexico and following the U.S. mid-term congressional elections. Furthermore, the U.S. would presumably prefer completing NAFTA negotiations, in order to concentrate on the larger challenges of trade tariffs against China. That move will entail far greater implications and complexities for the world's two largest trading nations. The possibility of a deal that keeps NAFTA in place, while changing some of the current rules governing the trade pact, could hinge on implementation of immigration reform between the U.S. and Mexico. The Administration's unhappiness with Mexico for not voluntarily curbing illegal

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immigrants crossing the U.S. border, could well push President Trump to walk away from NAFTA. As the Administration sees it, the mere threat by the U.S. to quit NAFTA, puts the Mexican side on the defensive and creates more of an incentive that they will agree to concessions on immigration. In other words, no one can say for certain where the current NAFTA negotiations will lead. The reality is that despite a positive economic outlook at the beginning of 2018, increasing global trade tensions [including NAFTA] have contributed to more uncertainty and intense market volatility. These uncertainties have the potential of altering the previously sanguine economic outlook, as investors and traders alike weigh the likely negative impact of high tariffs and other changes in the way companies have become accustomed to doing business overseas. Cross-border trade with or without NAFTA seems destined to become more confrontational and could begin to look a lot different going forward.