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The NAFTA in all its aspects

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During his election campaign, Donald Trump was a harsh critic of free trade, holding it responsible for the USA's trade deficit and the decline in US manufacturing jobs in the last 30 years.

Accordingly, after being invested as president in January 2017, Mr Trump ended the USA's involvement in the Trans-Pacific Partnership (TPP). That agreement, formed in February 2016 between 12 countries in the Americas and Asia¹ – including Mexico and Canada – had yet to be ratified by its signatories and so had not come into force. In August 2017, the US administration also decided to apply preliminary countervailing duties to Chinese aluminium foil, which it claims is heavily subsidised. In addition to these symbolic decisions, there have been several executive orders, including one requiring strict compliance with the Buy American Act². The government has also commissioned an enquiry into whether steel and aluminium imports are a threat to national security.

However, Donald Trump is paying particularly close attention to the renegotiation of the North America Free Trade Agreement (NAFTA), which was formed between the USA, Canada and Mexico in 1992 and came into force in 1994. Canada and Mexico are the USA's second- and third-largest trade partners behind China. The renegotiation is also important for Mr Trump's credibility, since he has suffered several political setbacks since he became president. Having threatened, during his presidential campaign, to scrap NAFTA if he could not change some of its aspects, Donald Trump started the process of renegotiating it on 18 May 2017.

Some positions adopted by the US administration since the renegotiation began have been fairly well received by Canada and Mexico. All parties wish to strengthen the agreement's labour-related and environmental aspects, and to include a chapter on the digital

economy that would guarantee the free movement of data and make it easier for companies to locate infrastructure wherever they wished. The three NAFTA members had also reached agreement on these matters when negotiating the TPP. However, some of the US administration's other proposals have sparked major disagreement. Canada and Mexico, presenting a united front, are particularly critical of the USA's desire to review anti-dumping or countervailing measures, and to change NAFTA's rules of origin.

To assess the issues involved in the NAFTA renegotiation, we will present, in the first section of this report, its current main provisions. We will then review the agreement's effect on the economies of its member countries. Finally, we will address the issues arising from the demands made by the US administration.

An overview of NAFTA

The genesis of the North American Free Trade Agreement

It was mainly the USA that initiated talks to set up a free-trade zone in North America. Links between Canada and Mexico were fairly limited, whereas the USA had for a long time been developing close relations with both countries. However, their trade relationships with the USA, with which they share both history and a border, have seen differing trajectories.

The Canada-US Free Trade Agreement: the precursor to NAFTA

Relations between Canada and the USA, which saw many bouts of turbulence until the mid-1930s, changed significantly following the signature of the General Agreement on Tariffs and Trade (GATT) by 23 countries on 30 October 1947³. The ratification of that agreement,

¹ United States, Brunei, Chile, New Zealand, Singapore, Australia, Peru, Vietnam, Malaysia, Mexico, Canada, Japan

² The BAA dates from 1933 and, subject to exceptions, requires the US government to prefer US-made goods when making purchases.

³ Canada and the USA have been members of GATT since 1 January 1948.



followed by several rounds of talks during the following years, caused the signatory countries to reduce customs duties, quotas and non-tariff barriers on goods.

In 1965, the USA and Canada also ratified the Auto Pact⁴. This was more of a managed-trade agreement than a free-trade agreement, but it eliminated customs tariffs on auto-industry products⁵.

The USA and Canada went further in 1987, signing the Canada-US Free Trade Agreement (CUSFTA). That agreement, which came into force on 1 January 1989, has brought a gradual elimination of customs duties and import and export quotas⁶ and a reduction in certain non-tariff barriers on products. The agreement, which was innovative at the time, also led to a greater volume of public contracts being open to competitive bids from suppliers in both countries. In addition, trade in some services, and investment rules, were liberalised. The agreement also included a dispute-settlement mechanism to resolve trade disagreements.

NAFTA: the result of an ambiguous relationship between the USA and Mexico

Mexico and the USA have often had a conflictual relationship, which has affected their trade links. The USA has invested massively in Mexico since the middle of the 19th century. The initial aim was to support Mexico's economy and avoid conflict. However, several events have led the USA and Mexico to forge increasingly close links since the mid-20th century, particularly at the time of the Second World War, during which Mexico supplied commodities and labour to the USA. Between 1942 and 1964, millions of Mexicans came to work on US farms as part of the "Bracero Program". When that agreement expired, assembly plants known as *maquiladoras*, mainly subsidiaries of foreign companies, were built in free zones on the border between the two countries, in order to provide jobs to Mexican workers. The goods produced in those plants used primary materials coming from the USA free of customs duties, and most of them were exported to the USA on preferential terms. The debt crisis in the early 1980s was another turning point. Mexico had to liberalise its economy in order to escape the debt crisis that rocked the country in 1982. It had become unable to finance its external dollar-denominated debt when the US Federal Reserve raised its interest rates to fight inflation. As a result, Mexico

had to seek help from the Bank of International Settlements (BIS) and the International Monetary Fund (IMF). The IMF granted Mexico a loan, on the condition that the country adopts austerity measures and liberalise its economy, i.e. promote free trade and foreign direct investment. The Baker plan⁷ in 1985 and the Brady plan⁸ in 1989 went in the same direction. Mexico gradually removed barriers to trade and investment from abroad, and became a member of GATT in August 1986.

President Carlos Salinas de Gortari, elected in 1988, continued to liberalise the Mexican economy. He also started talks aimed at reaching a trade agreement with Canada and the USA. Mexico had wanted to distance itself from the USA and create closer ties with European countries, but the latter, at the time of the fall of the Berlin Wall, had little interest in Mexico. As a result, Mexico decided to strengthen its trade links with the USA, which was a key trade partner for Mexico even before NAFTA. A trade agreement was therefore intended to maintain or improve Mexico's access to the US market through the scrapping of tariff barriers and the reduction of non-tariff barriers. Mexico was also hoping for jobs to be created through greater foreign direct investment from Canada and third-party countries, since those countries would be more confident that Mexico would no longer adopt protectionist measures.

Mutual interest

At the same time, since the start of the 1980s, the USA had wanted an answer to the creation of Europe's common market in 1958 and to the plan, unfinished at the time, to create the European Union and the eurozone⁹. To achieve that, the USA wanted to set up a free-trade zone in North America, in order to reduce production costs by importing lower-cost products and make its economy more competitive. The USA also wanted to boost Mexico's growth in order to stabilise its political situation and contain the flow of immigrants.

Canada had less of an interest than the USA in negotiating a free-trade agreement that included Mexico. The USA was already Canada's number one trade partner, and Canada had few links with Mexico. It was also tricky for Canada to start new trade negotiations given the domestic controversy that the Canada-US Free Trade Agreement had already caused. However, it decided to go ahead with the plan. For

⁴ The pact was incompatible with WTO rules, and was abolished in 2001.

⁵ The products included cars, trucks, buses, tyres and original auto parts. The agreement only concerned auto assembly companies already present in Canada. Producers also had to meet requirements regarding Canadian content.

⁶ Except in clearly defined circumstances, such as imports of pornographic material or agricultural products.

⁷ The Baker plan offered additional loans to the most indebted countries, mainly in Latin America, to allow them to continue their economic development.

⁸ The Brady plan proposed that bank creditors exchanged their claims for securities guaranteed by the international monetary authorities and the US Treasury, provided that banks wrote off some of their claims and put money back into the system.

⁹ The Treaty of Rome was signed in March 1957.



Canada, a bilateral deal between the USA and Mexico would have created a risk of seeing Canadian goods compete directly with US products incorporating Mexican components unavailable to it. Canadian products could also have found themselves in direct competition with Mexican goods in the US market. In that scenario, foreign investors might have focused on the US market, which would have given them free access to the US, Mexican and Canadian markets, unlike an investment in Canada.

In 1990, therefore, the USA, Canada and Mexico started discussions with the aim of reaching a trade agreement. Talks started in 1991 and ended in December 1992 with the signature of the North American Free Trade Agreement or NAFTA. It came into force on 1 January 1994, one year after the Maastricht Treaty that gave rise to the EU.

An ambitious agreement

Gradual reduction in customs duties and goods quotas...

NAFTA, which was based on the previous CUSFTA, was intended to scrap customs duties on goods and start a process to eliminate regulations and other non-tariff barriers, i.e. bans or restrictions on imports and exports. The aim was also to remove duties, taxes and costs on exporting goods to another party's territory. On 1 January 2008, the last of North America's customs duties and quotas were scrapped.

...and in technical barriers to trade

NAFTA members must accept the technical regulations and results of conformity assessments of the other parties, except where there are issues of security, protection of the lives and health of people and animals, the preservation of plants and environmental or consumer protection. Each party must also treat its partners no less favourably than it treats similar products or service-providers from any other country. NAFTA members, which must apply international standards and particularly those of the International Organization for Standardization (ISO), must also make their respective standards or conformity assessment procedures compatible, and ensure that their respective standardisation organisations co-operate.

Liberalisation of public procurement

As part of NAFTA, each country must give to the other members, where the amount of a contract is above a certain threshold¹⁰, access to

public-sector contracts that is no less favourable than it gives to its own products and local suppliers.

However, NAFTA contains certain exceptions. Some services are excluded, such as public services, transport and, in Canada's case, healthcare and social services. NAFTA expressly lists the public-sector companies covered. For example, the US Agency for International Development is excluded from NAFTA when it provides foreign aid. The US and Canadian agriculture ministries may exclude from the agreement purchases of agricultural products under farm support or food aid programmes. Certain contracts can also be reserved, in the USA and Canada, for small companies and those owned by members of minorities.

Federal states and provinces must also be consulted, and are only encouraged to open up their contracts. However, the 1994 Agreement on Government Procurement (GPA)¹¹, ratified by Canada and the USA as part of the WTO, along with the 2010 Canada-US Agreement on Government Procurement, have led federal states and provinces to open their public-sector contracts up to a little more competition.

Support for investment

Each party also undertook to treat investors and investments from other NAFTA members no less favourably than their own investors and those from third countries. In particular, a NAFTA member cannot require an investor from another NAFTA country to grant its nationals a minimum stake in a company located on its territory or to ensure that its production includes minimum national content.

Liberalisation of the service sector

NAFTA members must treat the other NAFTA members' service providers, except for providers of financial and aviation services, in the same way as it treats its own providers and those of third countries ("Most favoured nation" treatment). The agreement also intends to favour the practice or professional recognition of professional service providers, particularly lawyers, and to give engineers a temporary right to work. NAFTA members must guarantee the protection of intellectual property (patents, trademarks, copyright, geographical indications¹² etc.), and facilitate the temporary presence of businesspeople from certain professions so that they can make business trips across North America.

¹⁰ This agreement applies above certain thresholds. For federal public-sector entities between 1 January 2016 and 31 December 2017, the contract amount must be at least USD 77,533, or USD 89,600 for services, and USD 10.08 million for construction services. For public-sector companies, the contract amount must be at least USD 387,667 for products and services, and USD 12.4 million for construction services.

¹¹ The aim of the GPA is the mutual opening-up of government procurement. However, Mexico is not a signatory to that agreement.

¹² An indication is used to identify a product as coming from a party's territory, or a region or place in that territory, in cases where a specific quality, reputation or other characteristic of the product can be attributed essentially to its geographical origin.



Finally, the agreement created official dispute-settlement mechanisms, helping to resolve disagreements related to trade and investment between the various parties, and is accompanied by two related agreements.

NAFTA's related agreements

NAFTA members also formed two other agreements, the North American Agreement on Environmental Cooperation (NAAEC) and the North American Agreement on Labor Cooperation (NAALC), which both came into force in 1994.

The first agreement aims to encourage greater environmental protection across the territory covered by NAFTA. It gave rise to the Commission for Environmental Cooperation (CEC), which aims to increase environmental co-operation between the three parties. Each party must also ensure that the activities over which it has jurisdiction do not damage the environment of the other parties. For example, each party must ban exports to the other parties of any pesticide or toxic substance that is banned in its own territory. A party that breaches its environmental obligations may be subject to the same type of dispute-settlement procedure as those included in NAFTA for commercial obligations.

However, parties retain some leeway in determining their own environmental policies. Accordingly, the agreement does not affect the parties' existing rights and obligations under other international agreements relating to the environment. Parties also have the sovereign right to exploit their resources in accordance with their own environmental and development policies. Above all, however, the parties have the right to establish and modify their own environmental and development policies. In addition, no party can ask for its environmental legislation to be applied in the territory of another party.

The second agreement requires each member to apply its labour legislation effectively, and is intended to foster greater co-operation between NAFTA members. Again, however, members still have some leeway. The agreement is not intended to establish minimum requirements. Members have the right to determine their own labour standards and to modify their legislation in that area. The agreement only sets out certain labour-related principles, for information only. Those principles cover freedom of association and the protection of the right to organise, the right to collective bargaining, the right to strike, the prohibition of forced labour, protection for children and young people in relation to work, minimum employment standards¹³, the eradication of

labour discrimination for reasons such as race, religion, age or sex, equal remuneration between men and women, the prevention of accidents at work and occupational illnesses, compensation in the event of accidents at work and occupational illnesses, and the protection of migrant workers¹⁴.

NAFTA members today

An integrated free-trade zone

The USA is the hub for regional trade

There are close ties between NAFTA countries. Canada and Mexico are important for the USA given their respective clout in the world economy. Canada accounted for 1.3% of the world's GDP in 2016 and Mexico 1.9%¹⁵, and they are the USA's number one and number two export markets respectively. According to the IMF, 18.3% of the USA's goods exports went to Canada in 2016 and 15.9% to Mexico (see chart 1).

US goods exports by country

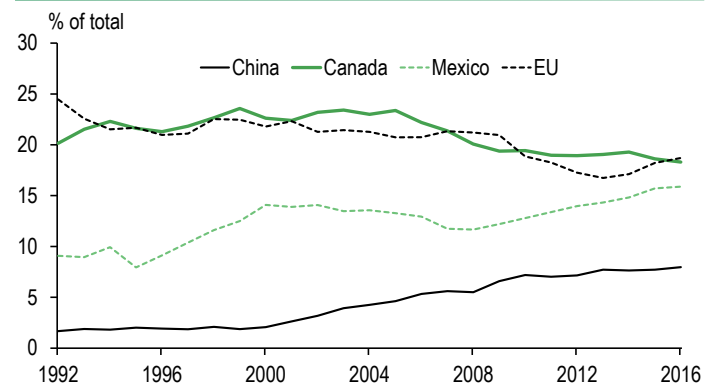


Chart 1

Source: IMF

Similarly, Canada accounted for 12.7% of the USA's imports in 2016 and Mexico 13.4%. However, Mexico and Canada account for only a small proportion of the USA's trade deficit (4.1% of GDP in 2016) compared with the volume of their trade. The USA's trade with Mexico resulted in a US trade deficit of USD 70.5 billion in 2016 according to the BEA (Bureau of Economic Analysis), i.e. 9.4% of the USA's total deficit, while trade with Canada accounted for only 2.2% of the USA's trade deficit (see chart 2).

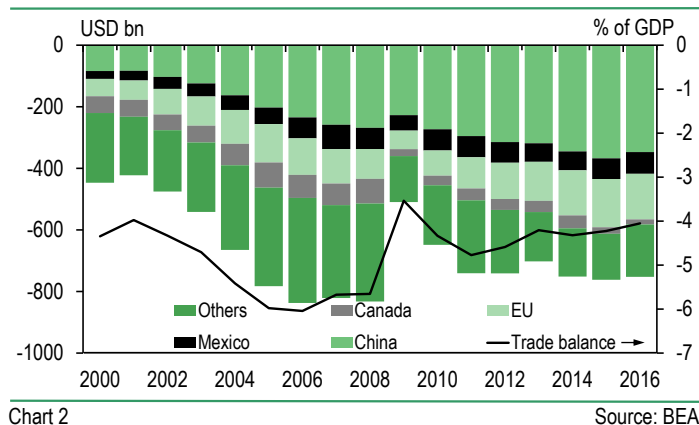
¹³ The establishment of minimum labour standards, such as the minimum wage and overtime pay, for employees including those not covered by collective agreements.

¹⁴ Granting migrant workers in one party's territory some of the same protection granted by law to that party's nationals regarding work conditions.

¹⁵ The USA, Mexico and Canada rank 2nd, 12th and 17th respectively in the World Bank's league table. GDP is expressed at purchasing power parity and in current international dollars.



US trade balance by country (in billions of USD)



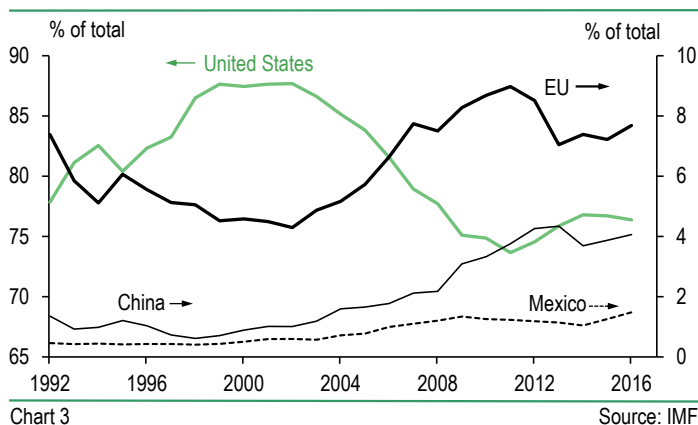
The USA, which accounted for 15.5% of world GDP in 2016, is the main trading partner of both Mexico and Canada. In 2016, 81.3% of Mexico's goods exports and 76.4% of Canada's goods exports went to the USA, while almost 46% of Mexico's imports and 52.2% of Canada's imports came from the USA (see charts 3 and 4).

However, there are few direct links between Mexico and Canada. Only 2.8% of Mexico's goods exports went to Canada in 2016, and only 1.5% of Canada's goods exports went in the opposite direction. Canada imports more from Mexico (6.2% of its total goods imports in 2016) than Mexico imports from Canada (2.5% of its imports), but they remain closely linked because of their strong ties with the USA.

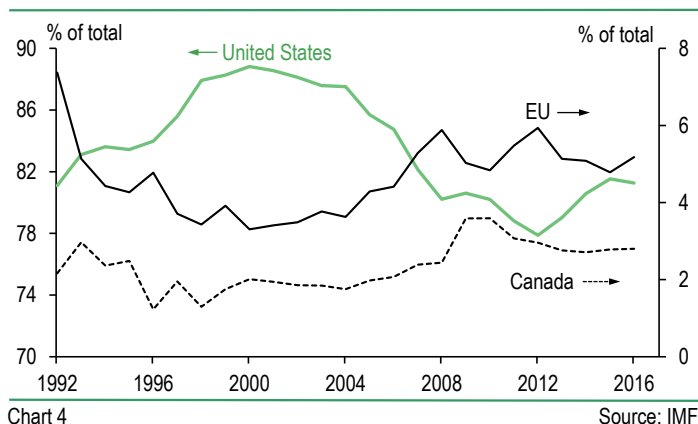
Production chains distributed across North America

The high level of trade between NAFTA members arises mainly because value chains have been deployed in their territory. US companies have a major presence in Canada and Mexico, showing how integrated the NAFTA economies are. According to the IMF, in 2015 the USA alone accounted for almost half of Canada's foreign direct investment stock and 43.7% of Mexico's, whereas Canada accounted for only 8.6% of the USA's FDI stock and Mexico 0.5% (see figures 5 and 6). The import content of NAFTA members' exports also shows the deployment of production chains within the region. OECD figures show that, in 2011, 9.4% of the value added of goods exported by Canada and 11.6% of those exported by Mexico came from the USA. The total import content of exports is much lower in the USA (15% in 2011) than in Canada (23.6%) and Mexico (31.7%), but NAFTA members still contribute to it. Canada accounts for 2.2% of the value added of US exports, and Mexico 1.3%.

Canadian goods exports by country



Mexican goods exports by country



Integrated auto production

The auto sector is probably the one that best illustrates the integration of NAFTA economies, because the import content of exports is high in that industry, and because there is heavy trade in vehicles and auto parts. Transport equipment, alongside industrial supplies and materials, are the goods most traded between the USA and its NAFTA partners (see charts 7 and 8). According to 2016 figures from the Bureau of Economic Analysis (BEA), the USA exported almost 60% of its vehicles and auto parts to its NAFTA partners¹⁶. Canada is the USA's number one export market in this sector, slightly ahead of Mexico. Similarly, almost half of the USA's imports of vehicles and auto parts came from Canada and Mexico (12.6% and 42.9% respectively in 2016). According

¹⁶ According to 2015 figures from the International Trade Administration (ITA), the USA exported almost 75% of its auto parts to its NAFTA partners.

to UNCTAD, 73% of Mexican vehicle exports are destined to the USA and almost 95% of Canadian vehicle exports.

The auto sector is therefore highly integrated. The USA produces almost a quarter of the content of the vehicles it imports from Canada and Mexico according to a PIIE study¹⁷. These figures are not directly comparable with the OECD's, which take into account all transport equipment, i.e. vehicles, parts and components. However, they show that in 2011, the USA was the origin of almost 18% of the value added of vehicles¹⁸ imported into Mexico and almost 26.4% of the value added of vehicles imported into Canada.

Inward investment position in Canada by country in 2015

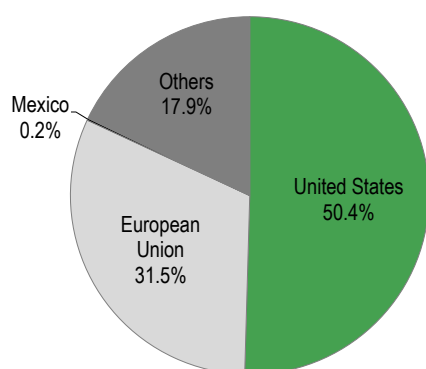


Chart 5

Source: IMF

Inward investment position in Mexico by country in 2015

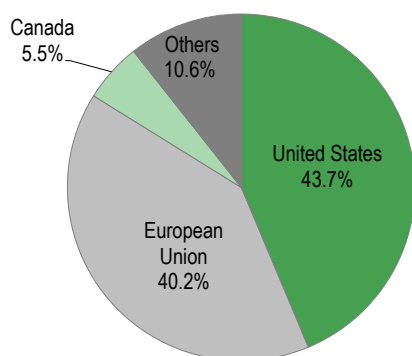


Chart 6

Source: IMF

US goods imports from Canada by products in 2016

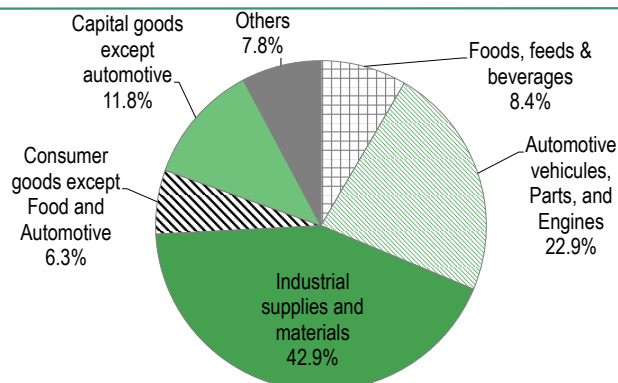


Chart 7

Source: BEA

US goods imports from Mexico by products en 2016

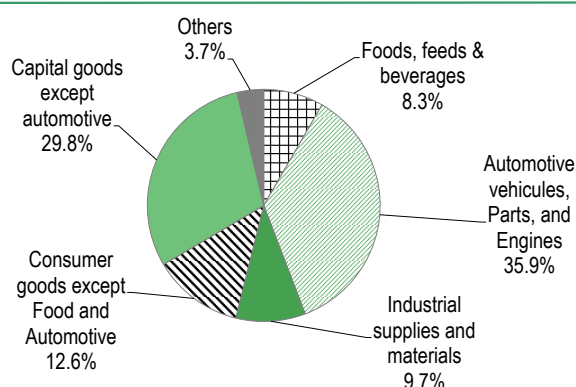


Chart 8

Source: BEA

NAFTA's impact: hard to quantify

However, despite the high level of trade, it is hard to gauge NAFTA's direct impact on its member countries over the last 20 years. The agreement was formed at a time when global trade was becoming more liberalised in any case due to the creation of the WTO (World Trade Organization) and the adoption of a new set of agreements that lowered average customs duties on manufactured goods. The most-favoured-nation tariff for all NAFTA countries fell sharply in the 1990s and 2000s. All of these factors, combined with technological progress, allowed companies to benefit fully from the comparative advantages of the various participants in global trade. During the 1990s, transport improvements and new information and telecommunication technologies made it easier and quicker to co-ordinate tasks across increasingly long production chains, spread across a growing number of production hubs located some distance away from each other.

¹⁷ Caroline Freund, *A US Content Requirement in Nafta could hurt manufacturing*, PIIE, 14 September 2017

¹⁸ Automobiles, trailers and semi-trailers

The issues raised by NAFTA also vary between economies, which differed substantially in the mid-1990s and still do today. This is shown by the wealth gap between the USA and Canada on the one hand and Mexico and the other. GDP per capita in the USA was almost three times higher than Mexico's in 2016, and Canada's 2.5 times higher (see chart 9).

GDP per capita (in thousands of international dollar (PPP))

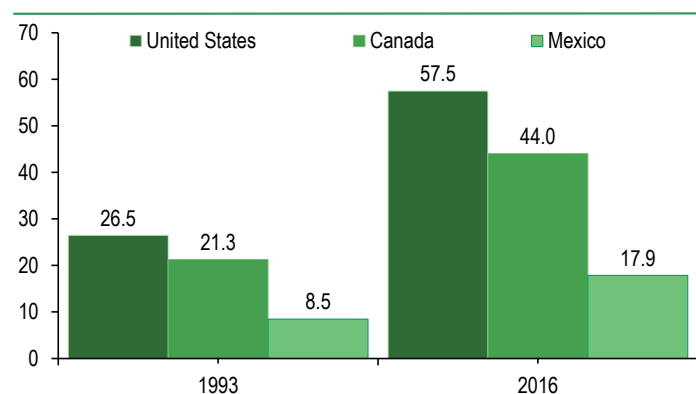


Chart 9

Source: World Bank

Smaller-than-expected impact for Mexico

NAFTA seems to have tied Mexico a little more closely to the North American market. A study by Caliendo and Parro (2014)¹⁹ shows that Mexico's trade within NAFTA grew 118% between 1993 and 2005 through lower customs tariffs alone²⁰. According to a study by Gary Clyde Hufbauer, Cathleen Cimino and Tyler Moran²¹, Mexico's GDP has grown an extra USD 170 bn, equal to around 13.5%, through higher trade within NAFTA in 2013.

However, NAFTA does not seem to have fully lived up to its members' expectations. Welfare, which is measured by trade and the terms of trade²², has increased only 1.31% in Mexico, according to the Caliendo and Parro study. Similarly, the gap between Mexico and the USA in terms of GDP per capita (at purchasing power parity) was just as wide

in 2016 as it was in 1993. However, it is hard to distinguish the impact that NAFTA has had from that of globalisation in the world economy and Mexico's domestic policies. It seems that the Mexican economy's persistent difficulties also result from deficiencies in its banking sector and a lack of control over public spending. These factors have restricted investment, technical progress and productivity growth in the last few years. Stagnating real wages, resulting from limited productivity growth, have weighed on Mexican households' real incomes²³.

Moreover, Mexico seems to be playing an increasing role in global trade. Trade between Mexico and its NAFTA partners increased sharply between 2000 and 2014, although more slowly than its trade with third countries. Mexico's exports to the USA doubled between 2000 and 2014 and its exports to Canada tripled, but those to its other trade partners quadrupled. Similarly, Mexico is importing increasing amounts of Chinese products. In 2016, 18% of Mexico's goods imports came from China, which was only a marginal trade partner of the country in the early 1990s.

NAFTA's limited impact on Canadian trade

NAFTA seems to have had much less impact in Canada than in Mexico. According to the Caliendo and Parro study (2014), intra-zone trade increased by only 11% in Canada between 1993 and 2005 because of lower customs tariffs alone, and welfare fell 0.06%. According to a study by Gary Clyde Hufbauer, Cathleen Cimino and Tyler Moran, Canada's GDP has grown an extra USD 50 bn, equal to around 4%, through higher trade in NAFTA in 2013.

However, NAFTA does seem to have influenced the structure of Canada's trade. Mexico has played an increasing role in Canada's trade over the last 23 years. Canada's goods imports from Mexico rose by a factor of around 9.5 between 1993 and 2016, while those from non-NAFTA countries rose by a factor of around 3.5. As a result, 6.2% of Canada's goods imports came from Mexico in 2016, versus 2% in 1993.

The situation is more nuanced in the USA. The USA accounted for much of the increase in Canada's trade between the early 1990s and 2000, and is still Canada's main trading partner. However, Canada has been diversifying its export markets, selling more to the EU, and has been importing more goods from Mexico and China since the late 1990s. The USA's share of Canada's total goods imports has therefore fallen, from almost 65% in 1993 to 52.2% in 2016. The same is true of the USA's direct investments in Canada, although its FDI stock almost quintupled between 1993 and 2016. In 2016, the USA owned almost

¹⁹ Caliendo, L., and F. Parro (2015), *Estimates of the Trade and Welfare Effects of NAFTA*, Review of Economic Studies, July 2014.

²⁰ The study selected that timeframe because, in 1993, customs duties averaged 12.5% in Mexico, 4.2% in Canada and 2.7% in the USA, but became almost non-existent within NAFTA from 2005 onwards.

²¹ Gary Clyde Hufbauer, Cathleen Cimino and Tyler Moran, *NAFTA at 20: Misleading Charges and Positive Achievements*, Peterson Institute for International Economics, May 2014

²² Welfare effects include trade in volume and terms of trade effects. The terms of trade represent the relationship, for a given product, between the export price index and the import price index.

²³ Sylvain Bellefontaine and Tarik Rharrab, *Mexico: US anchor called into question*, Conjoncture, February 2017

half of Canada's FDI stock, but that proportion has been falling since the early 2000s in favour of the EU and to a lesser extent China.

The diversification of trade has accompanied the rise of Asian countries and their integration within global value chains. The fall in Canada's export share in the USA market also reflects the deteriorating competitiveness of the Canadian economy relative to the USA because of weak productivity growth. In addition, the Canadian dollar appreciated in the mid-2000s (see chart 10).

NAFTA's patchy impact on US employment

According to the same Caliendo and Parro study (2014), intra-zone trade increased by 41% in the USA between 1993 and 2005 because of lower customs tariffs alone, and welfare rose 0.08%. According to a study by Gary Clyde Hufbauer, Cathleen Cimino and Tyler Moran, the USA's GDP has grown an extra USD 127 bn through higher trade in 2013, equal to around 0.8% of GDP. In the USA, however, the debate

regarding NAFTA centres on its impact on jobs and wages. Manufacturing employment as a proportion of total employment fell sharply in the 1990s and 2000s: having been 16.8% in 1990, it fell to 10.2% in 2016 (see chart 11).

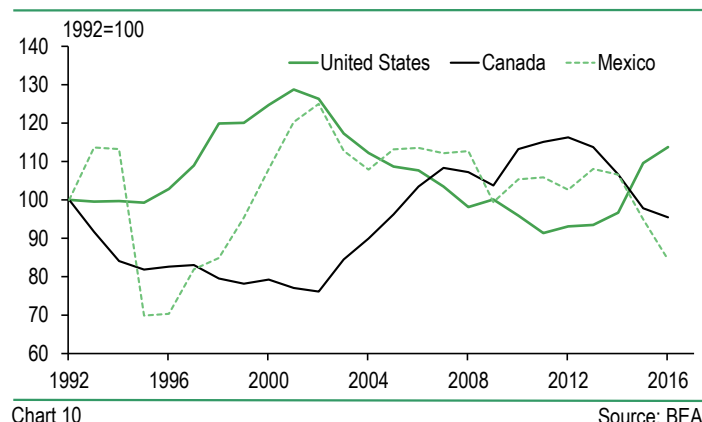
As a result, a number of studies have looked at NAFTA's impact on manufacturing employment and wages. Most of them show that NAFTA's total impact in the USA is sometimes positive, but always limited. The Caliendo and Parro study (2014) suggests that the reduction in customs duties was accompanied by a 0.11% increase in US real wages between 1993 and 2005. The study by John McLaren and Shushanik Hakobyan²⁴ also estimates that NAFTA has had little overall effect.

However, the impact has been significant for a small proportion of workers. The McLaren and Hakobyan study shows a reduction in wage growth for workers in industries and regions that have seen competition from Mexico. They also show that service-sector employees in those regions are also affected, even if they have not seen direct competition from Mexican employees. These employees are in competition with people who originally worked in an industry affected by NAFTA and who are looking for a new job in services. As a result, wage growth in an industry that saw reduced customs duties under NAFTA was, between 1990 and 2000, 17 points lower than in an industry that had not been affected by NAFTA. In addition, the wage growth enjoyed by an employee leaving secondary education was, between 1990 and 2000, eight points lower than that of an employee working in a region not affected by NAFTA.

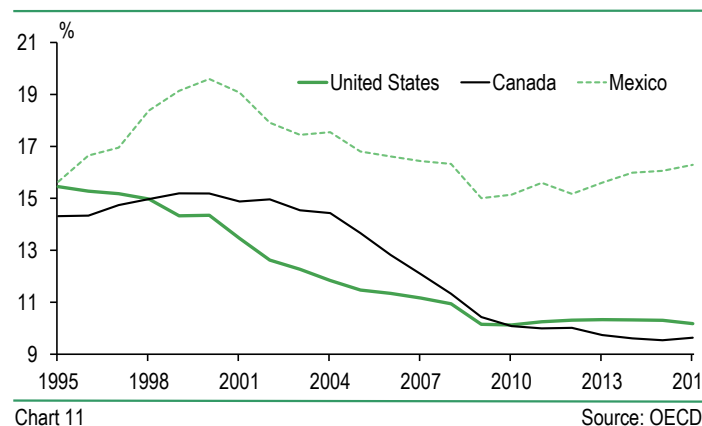
As a result, NAFTA's has caused jobs – particularly the least skilled jobs – to shift from the manufacturing sector to higher-value-added sectors. This fits with the HOS (Heckscher-Ohlin-Samuelson) model, which postulates that it is in a country's interest to export goods for which the required factors of production are relatively abundant (and therefore cheaper), i.e. skilled labour in the USA, and import goods for which the required factors of production are relatively rare, in other words unskilled labour.

However, the loss of manufacturing jobs is not solely due to free trade in general and NAFTA in particular. Other studies suggest that it is also the result of the technological progress that took place in the 1990s and 2000s. A study by Michael Hicks and Srikant Devaraj²⁵ posits that

Real effective exchange rate - Unit labour cost based



Share of manufacturing employment in total employment



²⁴ John McLaren et Shushanik Hakobyan, *Looking for Local Labor-Market Effects of NAFTA*, University of Virginia, Fordham University, June 2015

²⁵ Michael Hicks, Srikant Devaraj, *The Myth and the Reality of Manufacturing in America*, Ball State University, June 2015 and April 2017

productivity growth was behind 87% of job losses in the manufacturing sector between 2000 and 2010.

Renegotiating NAFTA

From the outset, NAFTA's negotiators made provisions for the agreement to be amended, provided that modifications or additions be approved in accordance with the legal procedures of each party. On 18 May 2017, therefore, the US administration initiated the process of renegotiating NAFTA, notifying its intention to Congress in writing, and was able to start talks with its trade partners on 16 August once the required 90-day period for consultation with Congress had expired. Since then, NAFTA members have held several sets of meetings²⁶. However, there will be many obstacles to reaching a new agreement given the differing viewpoints of NAFTA members.

The aim of the new talks

Consolidating existing rules

In July 2017, the Office of the United States Trade Representative published the US administration's general aims in the talks. In the report, the USA reasserted its intention to reduce its intra-NAFTA deficit. There is no longer any intention to bring back customs duties, but to attack non-tariff barriers which, and in certain areas such as agriculture, are still too numerous and discriminatory from the US point of view. The report calls for greater compatibility between the various parties' regulations, particularly regarding sanitary and phytosanitary measures. The USA also wants co-operation and transparency in technical trade barriers, requiring NAFTA members to publish their technical regulations and conformity assessment procedures, and to promote the use of international regulations and procedures, particularly those of the WTO.

The USA wants to NAFTA members to guarantee fair competition in the service sector, and particularly in telecoms and financial services, by combating discrimination against foreign providers and favouring cross-border data flows. Similarly, public-sector companies must ensure equal treatment when buying or selling goods and services. Competition must also not be skewed by the granting of subsidies. The USA wants customs procedures to be more transparent, simpler and faster, and wants to streamline the customs processing of shipments. It also wants to take fuller account of WTO recommendations regarding intellectual

property and avoid improper use of geographical indications by its NAFTA partners. The USA wants environmental protection measures to be an integral part of NAFTA, rather than merely being mentioned in an annex. However, it remains unclear how demanding the USA will be in terms of environmental protection, especially given that it has withdrawn from the Paris climate agreement, which Canada and Mexico have signed. Some proposals have been fairly well received by Canada and Mexico. However, others have been more controversial.

Employment law and the protection of workers

The USA wants worker protection measures to be an integral part of NAFTA, rather than merely being mentioned in an annex.

It is asking NAFTA members to recognise and incorporate in their own legislation the fundamental labour standards defined by the International Labour Organization (ILO), i.e. the freedom of association and the effective recognition of the right to collective bargaining, the elimination of forced or compulsory labour, the effective abolition of child labour and the elimination of discrimination in respect of employment and occupation. Member countries will have to adopt a legal framework enshrining a minimum wage, working time rules and health and safety at work.

The USA's demands in this area echo Donald Trump's criticism of NAFTA, i.e. that it encourages companies to move manufacturing jobs to Mexico, where labour laws are less strict than in the USA. However, talks in this area could be of limited effect. They involve minimum rules with which Canada, the USA and Mexico, as members of the ILO, are already required to comply. In addition, Mexico has ratified more ILO conventions than its partners, and although the proportion of unionised employees in Mexico is low (13.5% in 2014), it is slightly higher than in the USA (10.7% in 2014)²⁷. Of course, the minimum wage is lower in Mexico than in the USA and Canada, but protection for permanent and temporary jobs is weaker in the USA and Canada than in Mexico (see chart 12).

Improving access to government procurement contracts

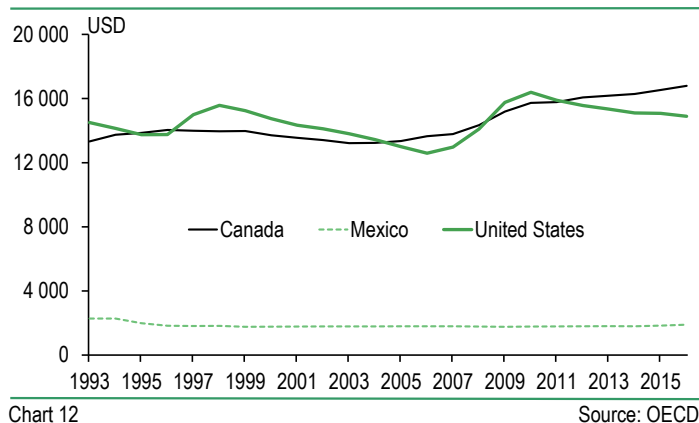
The USA wants to make it easier for US companies to access government procurement contracts in Canada and Mexico. However, it wants the agreement to maintain national preference for small companies and those led by women or members of minorities, and to exclude the defence sector as well as procurement contracts granted by federal states and local authorities. The USA is also demanding that the Buy American Act continue to apply where local projects benefit from federal aid. Government procurement procedures must also be

²⁶ Meetings have taken place in turn in the USA, Mexico and Canada, on 16-20 August, 1-5 September, 23-27 September, 11-15 October and 17-21 November 2017.

²⁷ In Canada, 26.5% of employees were unionised in 2014.



Real annual minimum wage



disapplied in certain cases, in order to protect national security, intellectual property and the lives and health of humans, animals and plants. These provisions are the same as in the WTO's Agreement on Government Procurement (GPA), which came into force in 1996 with the aim of mutually opening up government procurement contracts, and has been signed by Canada and the USA.

Possible changes to trade remedies

The US administration, which intends to limit imports from Canada and Mexico, wants to change anti-dumping and countervailing measures²⁸ relating to those imports. In particular, it wants to scrap the dispute-settlement mechanism described in Chapter 19 of NAFTA, which ensures that member countries comply with legal procedures and procedures relating to the establishment of evidence before imposing sanctions (anti-dumping or countervailing measures). In particular, the dispute-settlement mechanism guarantees a certain level of neutrality when resolving a dispute, and prevents these matters being dealt with before a national court²⁹. The US administration also wants to remove

exceptions to safeguard measures³⁰. These measures, which allow a country temporarily to restrict imports of a given product, must be applied non-selectively within the WTO framework (i.e. in accordance with the most-favoured-nation principle). However, NAFTA states that, without exception, safeguard measures of a member country must only apply to imports from countries outside NAFTA.

A very small proportion of imports from Canada and Mexico is currently subject to US restriction measures. According to work done by the Peterson Institute for International Economics (PIIE)³¹, 1.6% of imports from Mexico and 1% of imports from Canada were, in 2016, subject to sanctions under US trade laws³². By comparison, 9.2% of the USA's imports from China and 2.7% of imports from the rest of the world (excluding China and its NAFTA partners) were subject to the same restrictions.

This apparent tolerance originates from the high level of integration between the NAFTA economies. The major corporations that are susceptible, because of their size, to request that the US government apply sanctions, also usually have a presence in the other NAFTA countries. As a result, they would also suffer from any sanctions imposed on Canada and Mexico. Tolerance also results from the NAFTA clauses allowing member countries to disapply safeguard measures and challenge anti-dumping measures³³ or countervailing measures taken against them.

As a result, intense negotiations are taking place regarding the scrapping of the dispute-settlement mechanism and of the exception to safeguard measures. Canada and Mexico want to be able to continue protecting themselves against trade retaliation measures taken by the USA. They could even ask for NAFTA to limit the USA's use of national security laws, fearing that the USA will abuse them for the sole purpose of reducing imports from Canada and Mexico. Otherwise, the scrapping of the dispute-settlement mechanism and of the exception to safeguard measures could trigger a trade war between the three parties and destroy the benefits of NAFTA.

²⁸ According to the WTO, these measures, which allow a country temporarily to restrict imports of a given product, are "emergency" actions that can be taken when an absolute or relative increase in imports of a given product causes, or threatens to cause, serious injury to the importing member's domestic industry. The measures can consist of quantitative import restrictions (quotas) or of duty increases to higher than bound rates.

²⁹ The process starts with government-to-government consultation. Dispute-settlement provisions state that a party may "request a meeting of the NAFTA Free-Trade Commission (comprised of the Trade Ministers of the Parties). If the Commission is unable to resolve the dispute, a consulting Party may call for the establishment of a five-member arbitral panel. *"The parties have established several national rosters of individuals, who must be of high standing and repute and have been chosen strictly on the basis of objectivity, reliability, sound judgement and with a general familiarity with international trade law."*

³⁰ Safeguard measures may apply if imports from one party, regarded separately, make up a substantial proportion of total imports or if imports from one party regarded separately or, in exceptional circumstances from other parties regarded collectively, contribute materially to the serious injury caused by imports.

³¹ Chad P. Bown, Steel, Aluminum, Lumber, Solar: *Trump's Stealth Trade Protection*, June 2017, PIIE Chad P. Bown, *Trump's Renegotiation Could Take the "Free" Out of NAFTA's Trade*, July 2017, PIIE

³² These laws include anti-dumping, safeguard, countervailing duty and national security measures.

³³ Dumping is the practice by which a company exports a product at a price lower than its normal value, i.e. lower than the price applied "in the ordinary course of trade, for the like product when destined for consumption in the exporting country".

Tougher rules of origin

In 1994, NAFTA defined the rules of origin that are used to determine whether a product can benefit from preferential treatment. In particular, the rules are designed to ensure that a product traded within NAFTA is not a product that has come from a third country and undergone minor transformation, or that has been imported from a third country by the NAFTA member that has the lowest customs duties. Currently, a product originates in a party's territory if it is entirely obtained or produced in the territory of one or more parties, or if, through transformation, it has changed its classification within the Harmonized System (HS) of the World Customs Organization. In other words, its classification must be different from that of the non-originating material used to make it. The extent of the required transformation varies according to the product, but it may need a change of chapter, identified by the first two digits of the six-digit HS nomenclature. That would require substantial transformation of non-originating products. Aside from that requirement, a product may need to have a minimum regional value content. As a result, rules of origin vary by product, which explains their complexity and the scale of administrative costs involved when companies want to obtain a certificate of origin. In the auto sector, the required regional value content for a vehicle may be as much as 62.5% of the net cost³⁴. That means that 62.5% of a vehicle's components must come from NAFTA members, and only components that fully originate from NAFTA members are included in that proportion.

The USA wants to change these rules of origin in order to support its national production. It wants goods produced in the USA to include a greater proportion of goods produced in North America and the USA. It has the auto industry particularly in its sights, given the large portion of the US trade deficit attributable to it. The USA is apparently demanding that 85% of a vehicle's components come from North America and 50% from the USA.

However, it is not clear how changing the rules in this way will affect production in North America and the USA. The changes would generate additional costs. Companies could have to bear major costs in order to overhaul their production lines, which are already complex.

The USA's demands should be seen in the light of the current composition of vehicles produced in North America. Revamping the rules of origin in this way could therefore damage the competitiveness of companies operating in North America. It would make it even harder for them to purchase components from the most competitive suppliers.

³⁴ Net cost, which is the method favoured by NAFTA, is the total cost less sales promotion, marketing and after-sales service costs, royalties, shipping and packaging costs and interest costs.

As a result, the changes could prompt carmakers to flout the rule or move production outside of North America, so that they can use cheaper components, even if they have to pay, in both situations, customs duty of 2.5% when selling their vehicles in the USA³⁵. A company will be even less inclined to produce components in North America if the price of components made in a third country is lower than that of components made in NAFTA countries, and if the gap between the customs duty on the final product and the preferential tariff is small. The rules of origin could therefore have the opposite effect on US production from the one the US administration is seeking, especially since they could affect competitiveness in other sectors. The US approach could also prompt Canada and Mexico to take similar action, demanding a change to the rules of origin when a product or type of product gives rise to a large trade deficit.

All of these areas of disagreement could slow the pace of the talks, at a time when there are certain major events scheduled for 2018. Mexico will hold a general election in July 2018 and the USA will hold elections for all seats in the House of Representatives and a third of seats in the Senate in the November 2018 mid-term elections. These elections could make life harder for Donald Trump, because of the procedure that needs to be followed and the timeframe involved for a trade agreement to be approved by Congress. This fast-track Trade Promotion Authority (TPA) procedure, after which Congress will accept or reject the agreement negotiated by the administration without being able to table amendments, involves certain requirements to be met before and after an agreement is reached. Once the President has reached a trade agreement with the USA's partners, it takes 105 days before the text can be officially presented to Congress, during which time it is subject to various examinations. Then, it takes another 75-90 days before it can be put to a vote in Congress. In addition, this legislative procedure, which gives the US government extended powers regarding trade negotiations, expires on 1 July 2018 and will have to be prolonged by the President with the agreement of both houses of Congress until 30 June 2021.

Consequences if no agreement is reached

Competitiveness damaged by the introduction of customs duties

If NAFTA is abolished and in the absence of bilateral agreements, trade between NAFTA members would be governed by WTO rules. Members

³⁵ NAFTA members must comply with the most-favoured-nation clause, which means that a WTO member cannot discriminate between its trade partners. In other words, customs duties levied on a given country's imports cannot be higher than those levied on imports from the country with most-favoured-nation status.



could then more easily reintroduce non-tariff barriers (technical regulations, standards and conformity assessments, sanitary and phytosanitary measures etc.) and customs duties, provided that they comply with the most-favoured-nation principle, which means that a WTO member cannot discriminate between its trade partners. These customs duties, which currently average 3.5% in the USA, 4.1% in Canada and 7% in Mexico, can be very high, particularly on agricultural products.

Scrapping NAFTA would therefore damage the competitiveness of US companies and their sales in both the USA and third countries. US companies operating in Mexico would suffer from the higher cost of semi-finished goods imported from the USA and used in their production processes, because of the application of customs duties, especially since certain components cross the border several times before the finished product is assembled.

Revamp of production chains

Companies would also suffer from the abolition of or challenges to arrangements that facilitate and protect foreign direct investment or that allow the production process to be co-ordinated more easily between several countries, such as the ability to organise business trips easily. New trade barriers would therefore affect the integration of the North American economies and the whole production chain. A US company exporting to Europe could decide to locate its factories in a territory, Turkey for example³⁶, that provides security regarding its direct investment and from which it can export to Europe without customs duties. Similarly, foreign companies operating in North America and whose presence in Mexico or Canada no longer gives them preferential access to the US market, could repatriate production to their country of origin. For example, companies like Toyota could produce more in Asia. US companies could source auto parts from Chinese rather than American suppliers, in order to remain competitive.

Mexico would suffer particularly badly from a revamp of production chains. According to CAR (Center for Automotive Research)³⁷, almost 90% of new plans to build light-vehicle assembly plants have, since 2009, come from European or Japanese investors using NAFTA to export to the USA and North America. Foreign carmakers were, as a result, behind almost half of the light vehicles produced in Mexico in 2015.

³⁶ Relations between the EU and Turkey have been governed by a customs union since 1 July 1996.

³⁷ Center for Automotive Research, *NAFTA Briefing: Trade benefits to the automotive industry and potential consequences of withdrawal from the agreement*, January 2017

Auto sector hit hard

According to a CEPII study³⁸ examining how scrapping NAFTA would affect the auto sector, production would fall for all NAFTA members, but Mexico and Canada would be particularly badly affected because of their favoured position in the auto production chain. Mexico's production would fall by 17% and Canada's by 24%, while US production would decline only 1% because of lower sales to Canada. As a result, the USA would lose scale in the auto market, and would risk being less influential on the definition of standards and regulations in force in the sector.

Adjustment of activity in Canada

In Canada, some products would suffer from high customs duties, particularly in the agriculture, textiles and apparel sectors. However, according to a study by the Canadian Centre for Policy Alternatives³⁹, almost 40% of Canada's exports to the USA – consisting mainly of natural gas, hydroelectricity and aircraft – are currently subject to zero customs duties under the MFN principle. As a result, those exports would not be affected by the application of WTO rules. In addition, two thirds of Canada's other exports are subject to duties of 3% or less. The IMF⁴⁰ estimates that Canada's real GDP would fall by 0.4% in the short term if the USA applied an average MFN customs duty of 2.1% to its imports from Canada and in the absence of retaliation. The reduction in external demand would damage the profits of businesses and, eventually, investment and domestic consumption. Canada's trade balance would also deteriorate. The decline in the Canadian dollar would mitigate the impact of customs duties on Canadian exports, but at the same time the higher cost of Canadian imports would damage its trade balance.

Canada and Mexico, which respectively have 13 and 17 regional trade agreements currently in force, could eventually turn away from the USA and take advantage of trade agreements signed with other partners.

Conclusion

The positive effects of NAFTA have fallen short of the expectations that existed at the time it was ratified. The agreement has allowed its members to take advantage of global developments and create

³⁸ Thierry Mayer, *Brexit, Trumpit : la fin des accords régionaux ? Conséquences pour l'industrie automobile*, CEPII no. 371, November 2016. The study assumes that countries comply with the most-favoured-nation principle when establishing customs duties.

³⁹ Pierre Laliberté and Scott Sinclair, *What is the NAFTA advantage? Putting the tariff impacts of a rump termination in perspective*, Canadian Centre for Policy Alternatives, June 2017

⁴⁰ IMF Country Report No. 17/210, July 2017



integrated production chains across North America, but Mexico has not been able to close the gap in living standards with respect to Canada and the USA. However, the reasons advanced by the US administration for amending NAFTA are based on a flawed analysis of NAFTA's impact. In particular, job losses in the manufacturing sector cannot be attributed solely to NAFTA. They are the result of technical progress and the accompanying productivity growth.

Changes to rules of origin in the auto sector and challenges to anti-dumping measures, as sought by the US administration, could also damage NAFTA members, particularly the USA, which has taken advantage of Mexico's low production costs in order to improve its competitiveness. Companies could import their components or shift production outside North America, paying customs duties in both cases, in order to maintain competitiveness if rules of origin were tightened. The scrapping of the dispute-settlement mechanism and of the exception to safeguard measures could, at least in theory, create serious trade tensions between the three NAFTA members.

Abolishing NAFTA would also have serious consequences. New tariff and non-tariff barriers would affect the integration of the North American economies and the whole production chain. In that case, some North American and foreign companies would prefer to move production to other countries. If the USA were to restrict imports from Mexico, companies could import the same products from outside NAFTA. As a result, there would be little or no effect on the US trade deficit. Mexico could also retaliate and restrict imports from the USA, to the detriment of farmers⁴¹ and certain industries that export to Mexico or form an integral part of production chains.

All of these uncertainties should encourage the parties, which are currently sticking to their established positions, to reach a compromise. In this respect, the historic ties between Canada, the USA and Mexico suggest that they will settle their differences.

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⁴¹ In 2016, the USA exported almost 13% of its food production to Mexico.



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