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Managing risk, enabling trade

Goodbye NAFTA, hello USMCA

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Summary

- The USMCA has finally been signed on November 30 by the US, Mexico, and Canada, easing short-term uncertainty surrounding North American trade.
- The agreement must now be ratified by all three countries' legislatures with NAFTA rules staying in place until then.
- We expect a positive economic impact in the short term, especially in the automotive sector, through reduced uncertainty allowing business ties and trade flows between the three countries to strengthen.

The US, Mexico, and Canada finally signed the United States-Mexico-Canada Agreement (USMCA) on November 30, essentially keeping NAFTA alive, albeit under a new name. This follows months of negotiations leading to Canada, on September 30, joining an agreement struck by Mexico and the US on August 27 that replaces the 24-year-old free-trade agreement between the three countries. The deal has eased short-term uncertainty over North American trade, but it does not end the tariffs that the US has imposed on steel and aluminium exports from Canada and Mexico. Longer-term uncertainties still linger. Now that the deal has been agreed upon, it needs to be ratified by all three national parliaments. Getting the USMCA signed will likely be a bumpier road now that the US has a split Congress which could postpone implementation.

The key changes to the existing free trade arrangement (NAFTA) are:

Tighter rules of origin for the auto sector. The share of component parts produced within USMCA is raised from 62.5% to 75%; by 2023, 40% of a car's components will have to be made by workers with wages at or above USD 16 per hour (otherwise a tariff of 2.5% will hold). At least 70% of steel and aluminium used in the carmaking process should come from within the region.

Vehicle side letter. Canada and Mexico are shielded from global tariffs on cars that the US might impose on national security grounds by means of tariff-free quota well above current export levels.

Less strict sunset clause. USMCA will have a 16-year term, but it needs to be reviewed every six years.

Dispute settlement largely unchanged. USMCA contains some new restrictions to US-Mexico investment protection, such as more stringent requirements for local remedies. But these do not apply to investments in the energy, transportation and telecommunication sectors. Along with a less strict sunset clause, this is more beneficial to investments than the measures originally proposed by the US, but still adds to longer-term uncertainty.

Improved access to Canada's dairy market for the US industry to some 3.5%, as a concession for avoiding the five-year sunset clause and leaving the dispute settlement unchanged.

Trade with non-market economies. A three-month notice of the intent to pursue an FTA is required with a non-market economy and option to terminate USMCA. This essentially gives the US a veto over any trade deal between China and Canada and/or Mexico.

Expected impact on different sectors

Overall, the economic impact of the USMCA, once ratified, is likely to be limited, as it is effectively a small modification of the pre-existing NAFTA arrangement. Most importantly, the new trade agreement would significantly reduce trade uncertainty for the corporate sector in North America. It would allow trade to continue flowing and business ties to strengthen between the three countries. Corporates operating in the auto industry stand to benefit most.

Automobile

As a result of the tighter rules of origin and the continuation of tariffs on steel and aluminium, car production in North America will become more costly. The new rules are particularly challenging for Mexican car producers. Average wages in the Mexican auto sector are about USD 6 per hour, meaningfully lower than the USD 16 per hour requirement (data are based on information from the National Institute of Statistics and Geography). This means that in order to maintain competitiveness, the adoption of automation will likely be accelerated in Mexico and will continue in the US and Canada. Although the agreement might shorten auto supply chains, we do not expect it to result in more manufacturing jobs in the US. The vehicle side letter is particularly important for General Motors and for Mexican auto suppliers Metalsa and Rassini. GM imports more than 40% of its full-size pickup trucks and many of its crossover vehicles. Metalsa and Rassini are often the sole suppliers to GM.

Agriculture

The agreement provides new access for US chicken, eggs, fluid milk, cream, butter, skim milk powder and cheese. It also increases US access for turkeys. Canada's dairy farmers are unhappy about this. But the impact on the sector will be minimal (3.5% of Canada's market). Moreover, the Canadian government seems to be prepared to offer compensation to dairy farmers hurt by the deal.

Far more significant for US agri-business are the recently imposed tit-for-tat tariffs on US beef (Canada) and US cheese and pork (Mexico). Meat accounts for 13.6% of US agri-exports compared with 3.7% for dairy. Under USMCA these tariffs will stay in place. Their removal is contingent on the lifting of the US tariffs on steel and aluminum.

The most significant outcome of the new deal is that it eliminates downside risks to long-term agricultural output for the region. Under the new deal, NAFTA's zero tariffs on all food and agricultural products are maintained. Also, trade barriers on seasonal products exports to the US will be eliminated. This is good news for the sector given that Canada and Mexico are the first and third largest markets for US agricultural exports, accounting for over a quarter of total US agricultural exports.

The maintenance of the zero tariffs also eliminates the risk of food price inflation in Mexico, the largest importer of US grains and dairy.

Energy, telecommunication and transport

Under USMCA, the dispute settlement provisions within the so-called NAFTA Chapter 11 will largely remain intact for oil, gas, and power generation projects, as well as for investments in transportation and telecommunication. This removes a significant risk for investments in these sectors between the US and Mexico. The new agreement also states that Mexico has the direct, inalienable and imprescriptible ownership of all hydrocarbons in its subsoil. This reflects concerns of Mexico's incoming government that the agreement would limit the country's control over its oil resources. Still, the deal does not prevent foreign oil companies from producing oil in Mexico under the liberalisation measures of the industry passed by the outgoing government of Enrique Peña Nieto**.**

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