KPMG eurasia group

NAFTA insights

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Some progress has been made since the last NAFTA Insights, but negotiations may be facing increased headwinds on issues of greatest significance to each respective country. With Eurasia Group providing the latest developments from Round 3 of the NAFTA renegotiations, this edition considers what the quick wins and potential sticking points could mean for business.

So what's the latest on negotiations?

Once again, the third round of NAFTA negotiations concluded without tangible progress. Despite some optimism among negotiators about the pace of talks and remaining on schedule, the lack of real breakthroughs in Ottawa, and the absence of any formal proposals to amend the deal's most contentious issues, signals that the process is moving slower than anticipated. For instance, representatives discussed modifications to Chapter 19 dispute resolution mechanisms, but no consensus was reached.

A concerning sign is the emergence of new proposals that Canada and Mexico are unlikely to accept. The United States has taken a harsher position on rules of origin, proposed a sunset clause (that would terminate the Agreement at the end of five-year intervals, unless all countries agreed to extend), and suggested new seasonal restrictions on imports of agricultural goods from Mexico and Canada.

Nevertheless, **Eurasia Group's base case remains that a relatively painless renegotiation should be concluded by the end of the first quarter of 2018**, for several reasons. First, the United States is seeking to gain leverage on key issues, but by the end of the year, the Trump administration, according to Eurasia Group, will probably be willing to settle for whatever has been accomplished in order to avoid a delayed agreement.

All parties are aware of the timing risks—that is, the approaching electoral cycles in the United States and Mexico—and are therefore eager to avoid jeopardizing the deal. The main risk is that a delay would overlap with the campaign season and presidential election in Mexico to be held in July 2018. Incentives and strategies on the Mexican side will probably change as the election approaches as it will likely become more difficult to negotiate at a time when the opposition—in particular, frontrunner Andres Manual Lopez Obrador and his Morena party—will be very critical of the government's handling of relations with the United States. In the United States, a delay would run up against the elections for House and Senate in November 2018. Eurasia Group predicts that finalizing a deal may become more challenging if Democrats take control of the House of Representatives thereafter.

So what are the quick wins in the negotiations?

- On **small- and medium-sized enterprises:** In the most recent round, the trade representatives announced a new chapter focused on small- and medium-sized enterprises—to support the export of their products and services, and their integration into larger supply chains across the NAFTA region. For Mexico alone, this could benefit the four million plus registered small- and medium- sized companies (currently representing a mere 7.6 percent of total Mexican exports).
- On **regulatory practice:** Increased customs cooperation and improved cross-border movement of goods is unlikely to be contentious, and there have already been developments regarding core procedural issues (such as automatic declarations of origin, regulation harmonization, and electronic forms) in the latest round of negotiations.
- On **telecommunications:** Promotion of a major integration of the three markets for a sector that experienced recent reform in Mexico and was largely out-of-scope in the original agreement. The three countries also agreed to include some provisions related to **energy** in order to take advantage of the recent reform in Mexico, and promote regional investments and greater integration.
- On **e-commerce:** A nascent sector at the time of the original agreement, the renegotiations are likely to comprehensively address e-commerce operations. The only sticking point? The United States may push Canada and Mexico to increase their 'De Minimis' (tax) thresholds to streamline and harmonize the import process—and in doing so, increase the competitiveness of U.S. goods (thereby upping exports).

Other topics that look to advance quickly and comparatively easily include competitiveness; transparency and anticorruption; investment; and intellectual property.

What should you keep an eye on?

- **The sunset clause.** The United States has proposed to insert a sunset clause—meaning at a minimum that the Agreement will be re-evaluated in five years, and worst case would automatically terminate (without unanimous agreement to extend).

  From a business perspective, the inclusion of such a clause reduces certainty in investing in or carrying out operations within NAFTA territory because the "rules of the game" could change in a comparatively short time frame.

  For small- and medium-size businesses, this poses a bigger risk: these companies are more likely to be adversely affected by changes in rules that have the potential to impact operational costs. Larger companies are more likely to have the resources and infrastructure to mitigate the effect, but their long-term planning may be impacted—or the markets become less attractive—given the perceived uncertainty in legal framework (and therefore costs and profits of any given investment).
- **Rules of origin and the automotive sector.** Backed by a rhetoric of "winners" and "losers," the U.S trade deficit in the automotive industry is a cause of debate. The current proposals on the table: the inclusion of a minimum U.S. threshold as part of the Regional Value Content (RVC) rules of origin for automotive goods; and increasing the current RVC (currently 62.5 percent).

  While neither proposal was supported by Mexico or Canada, either proposal could impact significantly on the sector (as one that tends toward the most complex and most global of supply chains). Relevant businesses may need to consider the threshold at which it becomes more cost-effective to pay the Most Favored Nation (MFN) rate of import duty at U.S. customs.

More to come on: labor; environmental standards; dispute settlement; agricultural goods; state-owned and controlled enterprises; government procurement; and cross-border trade in services.

What should you be asking?

What is most important to business operating in a global economy isn't just whether the rules are negotiated in your favor. Rather, of utmost importance, recognized by the NAFTA negotiation teams, is that there be long-term predictability (certainty) in the agreement.

Clarity over renegotiations has been slow, and for every proposed viewpoint, there will be counter viewpoints. But, as we noted in our last edition, business can start analyzing the potential impact now. The next best thing to having the right answers is asking the right questions – as a snapshot:

- As the **Chief Executive Officer (and the Chief Strategy Officer):** Who in the business is responsible for monitoring, analyzing, and interpreting the impact of NAFTA renegotiations? Do proposed NAFTA renegotiations make the Canadian/Mexican/U.S. market a more attractive proposition through greater facilitation of trade? Which new or alternative markets should be explored as a result of changes to NAFTA – are there other preferential trade deals that could become comparatively more advantageous (such as CETA for the Canadians)?
- For the **Chief Operating Officer and the Chief Financial Officer:** What does a worst case 'US exits NAFTA' scenario mean for operational costs (at MFN rates)? What could this mean for your pricing strategy? How quickly can you reduce your supply chain dependency on the U.S./Mexico/Canadian market?
- As the **Chief Risk Officer:** Have NAFTA negotiations (and the risk of a withdrawal effective in six months) been factored into your risk framework, and have these plans been stress-tested?

As always, please reach out to us and the team for any questions, queries, or opportunities: [GO-FM Geopolitics](#).

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