NAFTA insights

October 2017 – Edition 4

Since the last NAFTA Insights, negotiations are getting tougher. With Eurasia Group providing the latest developments from Round 4 of the NAFTA renegotiations, this edition considers how negotiations could impact your cross-border trading and when you should act.

So what's the latest on negotiations?

The fourth round of the NAFTA renegotiation concluded on October 17 with Mexico and Canada firmly rejecting protectionist proposals from the United States. Although Eurasia Group considers that ultimately a deal is still likely (55 percent), a hardened U.S. stance and a tight deadline raise the risk that negotiations will falter.

Nonetheless, the decision following this round to extend the talks eased fears a U.S withdrawal from the deal was imminent. That said, Eurasia Group considers that there is a significant risk the U.S. administration may want to use the trigger of the withdrawal process to increase pressure on Mexico and Canada to accept U.S. demands rather than to walk away from the pact completely. Eurasia Group thinks this strategy would probably backfire given that Canada's and Mexico's first response would likely be to refuse to negotiate under those circumstances. The demands include several red lines for both countries, such as disruptive changes to rules of origins in the automotive sector, elimination of the dispute settlement mechanism, and a five-year sunset clause. Moreover, the perception that those changes will likewise face opposition in the United States reduces incentives for Mexico and Canada to accept them.

Eurasia Group points out that President Donald Trump's mounting frustration with Congress, the Republican Party, and his inability to deliver on his campaign promises in part explains why the United States has been taking a tougher and more extreme stance at the NAFTA talks. He is seen to need a political win and is probably looking to achieve one through the renegotiation process. However, Eurasia Group thinks that pressure from different groups, including his advisers, Congress, and the business community will likely be able to contain the threats and prompt Trump to walk back some of the "poison pill" proposals presented during this latest round.

Those proposals pertain to rules of origin for the automotive sector (a 50-percent U.S. content requirement and an 85-percent minimum for the region), dispute settlement mechanisms, Canada's supply management system, and government procurement. There is room for consensus on all proposals, with the issue of dispute resolution mechanisms being the most difficult one. Mexico and Canada will likely hold out on some of the less contentious issues, including final text for digital trade, anticorruption policies, and intellectual property rights, in order to gain leverage and find a middle ground. Ultimately, whether a deal is concluded is contingent on the United States lessening its demands.

The fifth round of negotiations has been scheduled for November 17–21 in Mexico City. Barring a surprise announcement by Trump, the next month will be relatively quiet as negotiating teams reassess their strategy behind closed doors.

So what could this mean for you?

While the negotiations are fluid, it is important to stay informed and understand how the issue will affect your operations.

The details and 'end game' of NAFTA negotiations remain unclear. But what we do know is that these 'known unknowns' will likely impact companies in three principle ways:

— **Ability to trade:** A renegotiation or a withdrawal could fundamentally impact your ability to sell a good or service cross-border (for better or worse) – for example, demands such as 'Buy American' would decrease access to public contracts for Canada and Mexico. Unpredictability for every company is a significant concern. Businesses must know the rules in order to secure financing and make investments necessary to stay competitive.

— **Efficiency of trade:** New provisions can make trade faster, cheaper, or more simplified. The opposite, of course, is also a possibility – for example, changes to the rules of origin could make them too onerous and costly to administer. As we mentioned in Edition 3, if preferential rates are no longer available, businesses must assess the costs associated with paying duty at the higher most-favored nation rates. If the overall costs to companies are prohibitive, they will need to consider supply chain changes, such as taking advantage of other preferential tariff regimes.

— **Protection of rights:** If the dispute mechanisms for Chapter 11, 19, and 20 are effectively eliminated, this would create additional exposure for businesses to retaliatory measures, such as antidumping/countervailing duties, surtaxes, and higher tariffs.

So how might negotiations impact your business?

We spoke last time about rules of origin, possible tariffs, regulatory practice, and e-commerce and digital trade (Edition 3), but efficiency of trading and the ability to trade may also be impacted by negotiations on:

— **Labor:** Canada and the United States have proposed to strengthen labor standards (applying recognized international labor standards, ensuring the right of creating labor collective associations, and making these provisions enforceable) – there may be some pushback, but expect a rise in labor costs and compliance for Mexican-based operations. Canada has also proposed freer cross-border movement of workers by expanding the job list.

Companies also need to understand if there will be impacts on their ability to send people to the United States to work with suppliers and provide after-sales service to American customers. For example, the ability of Canadian or Mexican professionals to provide services in the United States may be adversely impacted if the United States were to withdraw and eliminate the Trade NAFTA designation (TN immigration status, which was created through NAFTA).

— **Environment:** The current agreement has a relatively timid clause around environmental rollbacks. Expect the strengthening of environmental protections contained in NAFTA in order to dissuade investment attraction through lower standards. Not a surprising topic, given the disputes brought by foreign investors against Canada when it has rejected projects on the basis of environmental laws.

On the protection of rights:

— **Intellectual property:** Negotiations are likely to touch on greater consistency, if not harmonization of, intellectual property laws across the member countries.

— **Dispute settlement:** The United States wants to eliminate the Chapter 19 dispute settlement – a panel mechanism arbitration system that considers whether certain duties are being applied fairly. As mentioned, this could be a deal-breaker for Canada, as this chapter was adopted from the Canada-U.S. Free Trade Agreement (FTA) to ensure the timely, objective review of duties imposed by the U.S. government on Canadian imports.

Renegotiations may also extend to an overhaul of Chapter 11 Investor-State Dispute (ISDS) settlement provisions (i.e., companies versus governments).

Less efficient trade or the weakening of dispute settlement mechanisms can also impact the ability of a company to trade, or access, a market. As we are seeing in the recent case of Boeing and Bombardier, the proposed imposition of antidumping duties will, in practical effect, severely restrict access of the latter to the U.S. market – and the removal of Chapter 19 (or Chapter 11) would limit chances of quicker and easier redress in such a situation. Meanwhile, a withdrawal from NAFTA could increase comparative tariffs to the extent that Canadian softwood lumber companies become uncompetitive in servicing the U.S. market (for example).

On the flip side, renegotiations may open up market access in energy and telecommunications (Edition 3), in addition to potentially impacting the following:

— **Agriculture supply chain management:** Up for renegotiation are clauses around Canada's supply management system (dairy and poultry), which limits imports and sets fixed prices in the agricultural sector (the United States has something similar in place for sugar). Of course, increased competition from other countries may pose a real risk to Canadian-based operations. Regarding Mexico, the limitation of exports to the United States of specific products in determined time frames, is being examined but it is not likely that it will succeed.

— **Government procurement:** NAFTA currently provides for nondiscriminatory treatment in public procurement practices, but does not extend to subfederal public procurement. The United States is proposing to limit Canada and Mexico's access to U.S. government procurement contracts to a level equivalent to the combined access by the United States.

The U.S. government has historically purchased much more than the Canadian or Mexican counterparts; hence, this measure would assist in reducing the U.S. deficit.

So when should you act?

When you need to take action depends chiefly on what you do.

If a shift in the trading rules will merely make your operations less efficient (slower, more costly, more complicated), you may be able to delay executing on plans until you know more. But it is worth modelling the impact of how different scenarios will impact your business – just how much cost (or delay) will your business have to absorb before it is able to adapt? Some companies are already using various tools to identify issues and model such impact.

If NAFTA renegotiations or a withdrawal would severely restrict your business's ability to trade (wholly or for a particular product), immediate planning is necessary. When you need to execute depends on a number of factors – necessary lead time, the risk (cost) of it occurring versus moving first, etc. – but for a few companies, it may in fact need to be before negotiations wrap up (or a country exits). If you fall into this category, it is important not only to prepare impact models, but also to:

— Stay apprised of the status of the negotiations through access to intelligence and meaningful analysis to identify opportunities or potential exposure

— Assess impact with respect to supply chains, border delays, increased tariffs, employees working in other jurisdictions, etc.

— Assess current company structures and develop strategies in the context of potential changes

— Quantify tariff increases and identify opportunities to mitigate the increased costs

— Assess the impact on immigration and provide strategies to address the movement of employees working abroad (i.e., develop workforce planning and immigration strategies). For example, companies may want to focus on obtaining TN Status for certain workers in the United States as soon as possible. In addition, companies should focus on the window for workers to apply for the H Visa in the United States.

For certain companies, the NAFTA negotiations may open up a range of new opportunities. For other companies, the results of the negotiations may trigger significant disruptions to their supply chain. In either case, those companies that undertake scenario planning now will be the ones best positioned no matter what the outcome.

Interested in hearing more? Please join us for **Navigating Through NAFTA** Client Webcast, where we will share up-to-date and practical advice associated with the negotiations for a revised North American Free Trade Agreement (NAFTA).

Date: Thursday, November 2, 2017

Time: 11:00 a.m.–12:00 p.m. (U.S. EDT)

Register

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

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Key links

— KPMG's NAFTA Insights landing page

— KPMG's site for Brexit and geopolitics

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