KPMG eurasia group

NAFTA insights

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Since the last NAFTA Insights, little progress has been made, and it is becoming increasingly clear that the future of NAFTA negotiations will lie on the United States willingness to water down "poison pills." With Eurasia Group providing the latest developments from Round 5 of the renegotiations, this edition considers what no regrets decisions you could be making in light of this protracted uncertainty.

So what's the latest on negotiations?

On November 22, the fifth round of NAFTA talks concluded without significant advances. As expected, the round was marked by technical negotiations and review of the controversial proposals set forth in previous rounds by the U.S. team.

At the beginning of the round, the United States introduced a revised document of its priorities and objectives for the renegotiation. Underscored in this document is the United States' insistence on higher rules of origin, the sunset clause, reciprocity on government procurement, elimination of Chapter 19 on dispute settlement mechanisms, and changes to Canada's supply management system. Eurasia Group sees these as clear red lines for the Mexican and Canadian teams and, thus, talks continue to stall.

Now, negotiators from Canada and Mexico will draft counterproposals to the issues the United States has brought to the table. Eurasia Group predicts that the future of the renegotiations will depend on the willingness from the United States to water down its proposals. So far, the only topic with a formal counterproposal is the sunset clause. Mexico is proposing a periodic revision of the treaty instead of an automatic termination of the agreement every five years should one of the parties wish to withdraw. The United States did not seem to outwardly object to the idea, but a formal agreement has not yet been reached. Other issues such as rules of origin, dispute settlement, and supply management mechanisms were seemingly put on the back burner, but will be addressed in subsequent rounds.

On the less contentious issues, no chapters were closed either, although both Mexico and Canada announced in separate statements that there had been significant advances on anti-corruption, telecommunications, digital commerce, and good regulatory practices.

Despite the Mexican and Canadians' apparent reluctance to accept the United States proposals, Eurasia Group considers that it is unlikely that President Trump will send the letter giving a six-month notice of his intent to withdraw the United States from NAFTA in the near-term. Tax reform is seen as of greater importance; intervention in NAFTA negotiations would likely only generate friction with certain Republican representatives, who are big supporters of NAFTA, and Trump needs their support to pass proposed tax reforms.

That said, Eurasia Group predicts that Trump's incentive to send the withdrawal letter will increase toward the end of Q1 2018 as other domestic policy priorities fade to the background. Eurasia Group considers that the letter would only be used as leverage in the negotiations to pressure Mexico and Canada to accept the U.S. demands; Trump does not seem to want to eliminate NAFTA once and for all, or he would have done so already, according to Eurasia Group.

The willingness of the United States to continue negotiating past March, the result of the presidential elections in Mexico and the U.S. midterm elections will all impact the future of the renegotiations. In a scenario where the negotiations are not resolved, the original NAFTA framework would still stand but under increased uncertainty, which would likely hurt investment and slow trade in the region.

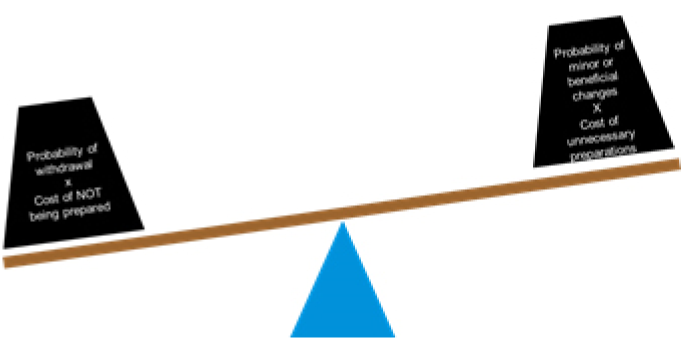
So should you "wait and see" what happens?

With uncertainty over the end goal likely extending to at least Q1 of 2018, if not longer, waiting and seeing the direction of travel before you take action can be entirely appropriate—so long as you have a plan and are prepared to take action.

Provided that some scenario planning is done in advance, as a general rule of thumb there is nothing wrong with waiting for greater clarity over the end state before (for example):

- Checking that your business model still makes sense in light of agreed changes to NAFTA
- Planning NAFTA communications, including engagement with affected individuals
- Considering whether your customer and brand propositions work with a "Made in" rhetoric (and possibly related policy changes)
- Review your current NAFTA processes, declarations, and certificates of origins to help ensure full compliance as we are witnessing greater scrutiny and enforcement
- Assessing impact on inventory, manufacturing footprint, contracts, intellectual property, or systems and processes
- Quantifying the cost per unit impact of changes to labor or environmental standards
- Considering whether you need to implement a new logistics plan

One caveat to this: It is important to identify any responsive actions that need a longer lead time. The (very) minor upside to a withdrawal (bluff or otherwise) is a ticking clock—and therefore clarity on the "when" to take action. Where any action needs more than six months to implement, now is the time to be weighing up the cost of preparing (and probability of withdrawal) against the cost of being caught out.



So what "no regrets" decisions could you take now?

The flip side of this is that there are a number of decisions that can be made or action take now at minimal cost or operational impact, that increase the preparedness of your business to mitigate—or take advantage of—possible changes to (or cessation of) NAFTA.

So while you wait for that clarity over the end state of negotiations, why not:

- Identify the person or position responsible in your organization to oversee and coordinate the necessary response.
- Think through your high-level strategy for the likely, credible alternative, unlikely, and worst case scenarios. As we've said before, this does not need to be extensive or complex—but it will help make sure you are ready to act, whatever the outcome.
- As part of this, identify the components of your business that fall within the scope of NAFTA: Which of your products benefit from NAFTA tariffs—and what are their comparative costs under MFN rates or alternative FTAs (e.g., Canada-U.S.)? What proportion of your employees are on an H-1 visa? And don't forget to think about second and third-order effects in your supply chain—are your suppliers heavily reliant on (for example) labor or parts from Mexico?
- Consider whether you need PR support to get your message through.
- Make sure the possibility of a future impact is considered in the course of any forward-looking business planning or review activity – for example, your pricing strategy today might look quite different in light of possible changes.

  A great example of this is U.S. Tax Reform: It appears likely that the most significant U.S. Tax Reform in 30 years is about to come to fruition. Furthermore, the changes in cross-border taxation are the most significant since the early 60s—when the U.S. Controlled Foreign Corporation regime was enacted. This means virtually any business with cross-border trade will need to review its supply chain and consider the tax impact of U.S. Tax Reform. In doing so, we strongly recommend any considerations be coupled with scenario planning around NAFTA. Anytime one is considering changes in the flow of goods or services from an income tax planning perspective, the issues such as trade and customs must be part of the work-plan. We are facing unprecedented changes to supply chains—now is the time to scenario plan.

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 geopolitics
- Eurasia's site for geopolitics

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