NAFTA Insights

September 2017 – Edition 2

Since the last NAFTA Insights, there have been comments via social media about the potential for US withdrawal from the Agreement and scrutiny of dispute resolution mechanisms, labor standards and local content rules. With Eurasia Group providing the latest developments from Round 2 of the NAFTA renegotiations, this edition considers whether the US President can withdraw from NAFTA – and the ‘all bets are off’ scenario that you should build into your business planning.

So what’s the latest on negotiations?

On 5 September, Mexico, the US and Canada concluded the second round of NAFTA negotiations in Mexico City. Overall, the negotiations unfolded as predicted but without significant progress on key issues.

On the positive front, the representatives from the three countries were able to meet despite US President Donald Trump’s recent threats to abandon the deal and consternation that an agreement would not be achieved. This shows the commitment of the negotiating teams to move forward and focus more on the technical discussions.

However, this second round did not result in any substantive progress. The three countries released a joint statement announcing that they had compiled the agreements of this second round in one single text that included new ideas and the consolidation of existing proposals (negotiations in sectors such as energy, telecommunications and financial services will be run swiftly), but US negotiators, while pushing to amend the treaty, have not released specifics on the key changes they want to implement.

This underscores that the parties’ desired timing of the negotiations remains in jeopardy. If the process slows and the three parties do not start to show progress in subsequent rounds (the next meeting will be held on 24 September in Canada), the prospect of reaching a deal in the near term could be threatened by the overlap between the negotiations and the Mexican Presidential elections next year. It will be very difficult for the Mexican authorities to negotiate when the elections are in full swing.

These talks also previewed some of the most contentious issues. Canada, backed by Mexico, continues to reject the elimination of the dispute resolution mechanisms stipulated in Chapter 19. Also, the US will try to increase the rules of origin and potentially promote US content in manufactured products, especially in the automobile sector. Finally, labor has taken a central spot, with both Canada and the US demanding that Mexico raise wages and implement stricter enforcement of labor laws and union rights.

So could the US President withdraw from NAFTA?

Much like Brexit Remainers have pondered the legality of reversing Article 50, the latest tweets suggesting possible US withdrawal from NAFTA have raised the question of whether the US President has the authority to unilaterally withdraw from the Agreement.

And like Brexit, there is no easy answer. Article 2205 of the Agreement allows parties to withdraw with 6 months’ notice, but the key question is whether the President could invoke this without the consent or approval of Congress.

The US Constitution conveys authority to both the President and Congress in matters of foreign affairs. NAFTA was enacted into law by the NAFTA Implementation Act (NIA), but the NIA is silent on the question of who has the authority to abrogate the agreement (i.e. there is no explicit authorization within the NIA for the President to unilaterally invoke the termination clause without Congressional approval). Unless a US law has a ‘sunset’ date of self-termination, only Congress has the authority to repeal an existing law, subject to presidential agreement, veto, or congressional veto override.

Should the US President move to unilaterally withdraw without Congressional approval, the issue may be litigated before the federal courts. For more detail on the legalities of a potential withdrawal by the US, see KPMG in the US’ *Trump and the NAFTA*.

So what could a US withdrawal mean?

Tariffs will likely increase – the question is by how much. The current preferential NAFTA duty rates will remain in effect for 1 year in the event of a withdrawal. However, the US President may, by proclamation, restore the pre-NAFTA duty rates. The president must then, within 60 days after the withdrawal, provide Congress “recommendations as to the appropriate rates of duty for all articles which were affected by the termination or withdrawal.”

Of course, this could occur even without withdrawal – the US President may at any time terminate or modify any proclaimed NAFTA preferential tariff rates as the president determines to be necessary or appropriate (although depending on the authority invoked, Congress may need to be consulted). In such a situation, counter tariffs may also be imposed by Canada and Mexico.

Any increase to the NAFTA preferential rates would generally be limited to the Most Favored Nation (MFN) rate under WTO terms – i.e. tariff rates could not exceed those on goods from any other WTO member country. The impact will of course vary by goods and sector, and may in fact be limited – most have even been reduced to zero under the WTO.

But these limits could be circumvented under exceptional circumstances. Certain conditions presently exist that may be invoked to trigger said extraordinary measures – for example, current US deficits, other trade imbalances, the general war on terror, or the specific conflicts in Iraq and Afghanistan. These conditions could also potentially permit the US President to raise tariff rates beyond the MFN rates pursuant to the security exceptions of the WTO Agreement.

It is also unclear whether a US withdrawal from NAFTA gives renewed effect to the United States-Canada Free Trade Agreement, which was effectively suspended when NAFTA was implemented.

US customs and compliance provisions could be impacted. Congress could legislate to preserve certain sections of the NIA, but as it currently stands, a withdrawal from NAFTA could affect other provisions of the NIA relating to general customs compliance and enforcement in the US (for example, the ‘reasonable care’ compliance standard upon US importers). The repeal of the NIA could potentially have a disruptive impact on importers and the trade compliance community in the US, even if they are not importing from Mexico, as well as US government enforcement actions.

Other markets could start looking a lot more attractive. Withdrawal from NAFTA does not mean loss of access; geography and size of the respective markets (and inertia) will ensure trade flows within North America remain an attractive proposition. But the removal of the preferential treatment under NAFTA may result in the three governments (and business) respectively focusing their energies on other markets – whether it be the EU (CETA), BRICs or the ASPAC region (TPP minus the US).

So what should you be planning for?

Here’s a recommended ‘Survival Guide’ for the next 6 months:

- **Decide upfront if you want to have a voice.** With the exact outcomes unknown, businesses can participate in the debate, sharing their concerns and assessment of the practical implications on their business with industry associations and other stakeholders. It is essential for any business exposed to NAFTA via trading links through Mexico, US and Canada to understand the implications of various possible outcomes. Engagement involves time, effort, cost and risk and you might decide that it’s not worth it — but let that be an active choice with eyes wide open.
- **If you aren’t already a scenario planner, become one.** You may think that NAFTA renegotiations are not likely to pose a material threat to your business, but in these uncertain times, these risks may be unpredictable. The possibility of withdrawal from NAFTA, however unlikely, increases uncertainty around the long-term prospects, costs and compliance obligations of doing business across not only North America, but globally. Consider the impact it might have on your customers, suppliers and even employees, and develop contingency plans to deal with any potential changes to business and supply chains. This does not need to be extensive or complex— it just needs informed thought and credible challenge, both internally and externally.
- **Embrace the idea of planning with flexibility:** We are big proponents of contingency planning. The key is to separate the knowns from the unknowns in order to have a manageable set of possible business responses. An example may be to have a back-up plan mapped out to the extent possible if there was an X percent increase in tariffs, or a Y percent change in regional (or even country specific) content. KPMG professionals stand poised to share their experience in building out such contingency planning with businesses — large and small and across every sector.

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 site for Brexit and geopolitics
- Eurasia’s site for geopolitics

KPMG in Canada, Mexico and the US and Eurasia Group have jointly published this briefing to provide clients with unique insights that combine Eurasia Group’s forward-looking analysis of political developments with KPMG’s knowledge and experience across audit, tax, advisory and company-level business implications.

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