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NAFTA Insights

March 2018 – Edition 7

Since the last NAFTA Insights, it appears that although parties are still committed to NAFTA, there is downward pressure to reach a deal by July. With Eurasia Group providing the latest developments from Round 7 of the NAFTA renegotiations, this edition considers the implications of the recent US Section 232 tariffs on the steel and aluminum sector.

So what's the latest on negotiations?

The seventh round of NAFTA negotiations recently concluded in Mexico City on 5 March. The teams advanced on some of the technical issues, including closing three chapters: good regulatory practices, transparency, and sanitary and phytosanitary measures, as well two sectoral annexes on chemical substances and food quality. This amounts to a total of six chapters closed thus far (out of 30) as well as four sectoral annexes. Judging by the tone of all three chief negotiators' in their joint statement at the end of this round, Eurasia Group suggests that the three governments are still intent on advancing towards a deal.

But the round concluded with seemingly little progress on the most contentious issues and the renewed uncertainty that resulted from US President Trump's announcement to impose tariffs on steel and aluminum certainly didn't help. On 8 March President Donald Trump announced that the US would institute a 25 percent tariff on steel imports and 10 percent on aluminum imports effective 23 March. He also indicated that Mexico and Canada will be granted a temporary exemption as long as NAFTA renegotiations are ongoing – which Eurasia Group considers a sign that the US remains interested in reaching a deal.

Eurasia Group considers that renegotiating NAFTA could represent a double win for the President – on the one hand, it keeps a campaign promise to his constituency in manufacturing states that were expecting to see changes on trade policy. On the other, the traditional republican party and the red states in the corn-belt would prefer to see NAFTA still in place, as they have benefited from exporting agricultural goods to Mexico. As such, Eurasia Group expects that the US negotiating team is still committed and will make strong efforts to finalize a deal (especially ahead of the midterm elections in the US).

That said, Eurasia Group highlights the protectionist turn in the US and the flight of pro-trade advisors from the US administration as an additional source of concern. There are a number of developments that could point toward a hardened US position (in a context in which compromise was already difficult): the resignation of the head of the National Economic Council Gary Cohn, who Eurasia Group considers as one of the more moderate advisors on trade, the departure of Secretary of State Rex Tillerson, and the increased influence of figures such as Peter Navarro, who had been critical to NAFTA and overall trade policy. As there is not much time left remaining in negotiations, this shift in trade and foreign policy heightens the risk of delays.

Mexico and Canada will try to keep the two issues as separate as they can and keep working towards a deal, but they will face increased complications and it will also make it tougher for negotiations to rise above the Mexican electoral cycle. While Eurasia Group felt that a deal was on balance likely by July (55 percent), the US President's announcement puts downward risks to that scenario. If there is no deal in July, then Eurasia Group suggests that the outcome of talks will become contingent on the Mexican election. A Lopez Obrador victory (60 percent probability assessed by Eurasia Group) would make it challenging to negotiate after the election and before he takes office in December. Once in office, Lopez Obrador's views and his rejection of any deals made by President Enrique Pena Nieto administration would complicate the talks and likely prompt the negotiations to be prolonged beyond 2019.

Even with the US President's announcement on steel and aluminum tariffs, Eurasia Group still sees a low risk of a full withdrawal from NAFTA given that Mexico and Canada are cooperating and that political, legal and economic challenges would mount. But Eurasia Group highlights that a protracted negotiation is becoming increasingly likely, and that would also increase risks of tougher actions from the US as well.

But what if the exemption was removed?

Recent actions from the US administration, in particular the imposition of steel and aluminum tariffs under Section 232 of the Trade Expansion Act, has created a large degree of global trade uncertainty. For the US, the conflation of the 232 tariffs with the NAFTA negotiations continues this Administration's trend of shaping trade policy through enhanced trade enforcement.

Currently, Mexico has a deficit in the balance of trade with the United Statesin the steel and aluminum sectors. However, potential impositions of tariffs on Mexican steel and aluminum could mean a significant impact to Mexican exporters, since the United States is their primary customer and it would not be an easy task to identify alternative destinations to diversify export markets.

In comparison, Canada supplies an estimated one sixth of all the steel used in the US and more than 40 percent of its aluminum, and even government agencies are reacting to the increased level of trade uncertainty. For example, the Bank of Canada cited uncertainty in trade policy developments and the potential impact on the Canadian economy as one of the reasons it has opted not to increase its interest rate.

Additionally, although indirectly, an impact could be expected in the production value chains, especially in industries that heavily depend on steel and aluminum as raw materials, or on inputs manufactured with them, such as the automotive, heavy machinery and home appliance industries, among others. These new tariff impositions, even regarding steel and aluminum imported by the United States from other countries, could cause important disruptions by increasing the costs of the raw materials and inputs to be used in the following stages of the value chains.

In Mexico around 44 percent of the foreign direct investment is related to the manufacturing sector and around 4.1 percent to the construction industry. Almost half of the foreign direct investment in Mexico is originating from the United States and almost 6 percent from Canada; hence, this is a good indicator of the strong interdependence between the NAFTA members. Due to this, any controversial issues such as tariff impositions may deeply affect both Mexican, American and Canadian interests, given the high utilization of these kind of industries of steel and aluminum products.

So where are the opportunities?

Nonetheless, this uncertainty presents an opportunity for Canadian and Mexican companies that export to the US to re-examine their scenario planning and ensure they would be able to absorb any potential increased tariffs.

In the US, for example, assessing the impact of the additional Section 232 steel and aluminum tariffs may be just a glimpse of things to come with NAFTA 2.0 however, the go-forward strategy should be familiar. Companies are advised to (1) assess their current state and understand the products and volumes that will be impacted, (2) assess the potential monetary impact of increased tariffs (i.e., the "known unknowns"), (3) consider additional/alternative sourcing options in the short- and long-term and (4) explore strategies to minimize the disruption (think foreign trade zone, duty drawback, first sale for export, etc.).

This also comes at a time when Canada is continuing to expand its free trade talks around the world, which in turn is opening up Canadian imports and exports to new markets and reducing tariffs in key markets. Last year, Canada successfully signed with Europe the EU-Canada Comprehensive Economic and Trade Agreement ("CETA") that came in to force on 21 September 2017 and on March 8, 2018 also signed the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) agreement, along with its NAFTA partner Mexico. CPTPP, considered to be one of the world's largest trade agreements even with the withdrawal of the US, opens up Canadian exports to markets like Japan, Malaysia and Vietnam, where there had previously been high tariffs and no preferential treatment. Further, Canada has launched trade talks with Mercosur group in an attempt to open up Canada to the markets of Argentina, Brazil, Paraguay and Uruguay. Despite the fact that CPTPP will likely not be ratified until Fall 2018, both CETA and CPTPP present an opportunity to assess if any of the new free trade agreements and tariff reductions offer the chance to diversify outside of the US market.

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

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