

NAFTA 2.0: What does this mean for Canada?

A Nafta agreement finally seems to be in sight but there are still some stumbling roadblocks. But for how long can the Canadian central bank maintain its 'wait-and-see' approach?



Source: Shutterstock

After seven rounds of negotiations, pressures for a new NAFTA deal are mounting. The fact there are local elections in Canada as early as June, Mexican elections in July and US midterms in November means that striking a new deal in upcoming weeks is crucial so that members of the current US Congress have enough time to approve the changes.

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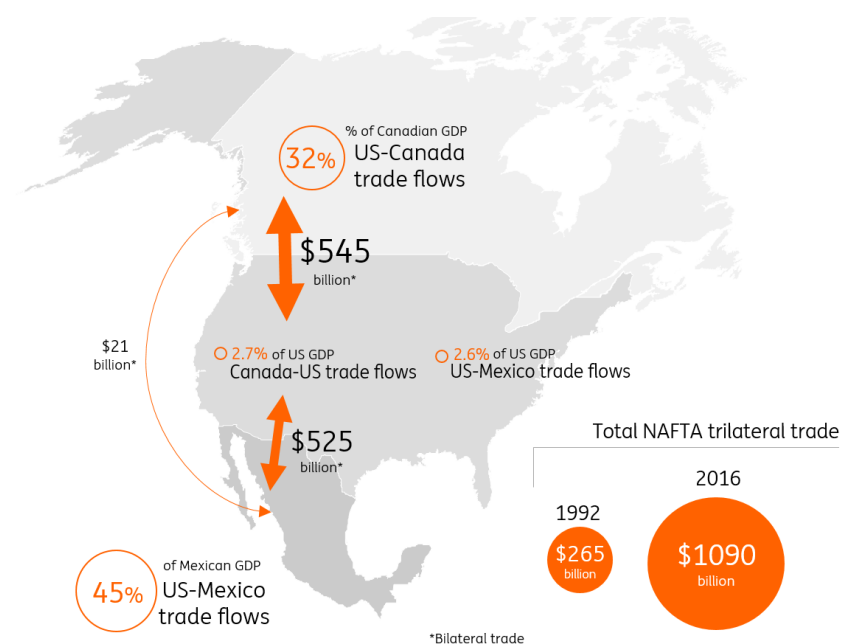
The Trade Promotion Authority (TPA) which allows President Trump to negotiate international agreements that Congress can then accept or reject but not amend, is also due to expire on 1 July unless Trump requests for its renewal.

Additionally, the clock is ticking on the reprieve given to Canada and Mexico on the US steel and aluminium tariffs on 1 May.

As explained in our [recent trade article](#), this would be harmful to Canada and Mexico who export high proportions of their total steel and aluminium output to the US. The possibility of a US-China trade war, which has incentivised Canada to finalise the agreement as an escalation would take up the full undivided attention of the US.

Should NAFTA break down this would be detrimental to the Canadian economy where US-Canada trade flows are worth 32% of Canadian GDP, as opposed to only 2.7% of US GDP.

NAFTA trade flows



Source: Macrobond, ING

The US had pushed for a preliminary pact to be announced at the Summit of the Americas today and tomorrow. However, this seems to have fallen-flat with talks scheduled to continue next week following President Trump and US Trade representative Robert Lighthizer's summit-trip cancellation, given ongoing tensions in Syria. This is hardly a surprise because, despite the talks progressing, the countries remain poles apart.

President Trump has recently said he is willing to 'renegotiate forever' amidst a retreat on autos, which is slightly more reassuring than his previous threats to abandon the deal altogether. However despite this, the recent US softening towards the sticky topic of automotive content has boosted confidence, and according to the Mexican Economy Minister, Ildefonso Guajardo, there is about an 80% chance that a deal will take place by the first week of May.

The fact that the rating agency Moody's changed their outlook on Mexico's sovereign ratings from negative to stable, explicitly stating solid NAFTA engagements as a reason behind this also reflects the optimistic outlook.

What are the stumbling blocks?

Despite the positive tone, there is still a wide-divide on a number of key issues. Given the fact that there is little time left before 1 May, a deal in principle seems the most realistic outcome, giving a bit of certainty and breathing space to the so far bumpy reshaping of NAFTA, but this is heavily reliant on negotiators compromising on several contentious topics.

1 Rules of origin

The rules of origin have been a sensitive issue for NAFTA negotiations with the US initially demanding that auto manufacturing had to contain 85% North American content up from 65% and 50% US-specific content. Since then a breakthrough in talks saw the US drop the 50% requirement and instead suggest a 'tiered-system' where only certain vehicles parts (the larger, more profitable ones, e.g. engines) would need to meet the 85% requirement. This would be created alongside an expansion of the 'tracing list' which tracks the origins of car parts. This has been countered by Mexico with an offer to increase the overall requirement of North American content to 70%.

The US has also recently proposed that there should be wage requirements for the auto industry, where certain amounts of auto production must be carried out in areas paying higher salaries - a beneficial proposal for America and Canada whose trade unions claim that low Mexican wages have seen manufacturing capacity shift in Mexico's favour.

This topic is likely to be heavily discussed next week, and we don't see any deal, preliminary or real until this topic is settled. Canada and Mexico have warned against these demands saying that a complex supply chain system would cause companies to pay US tariffs instead of complying with the US' requirements.

2 Sunset Clause

Several stumbling blocks remain including the sunset clause, a provision that would cause NAFTA to expire every five years unless it is re-approved by all three countries involved.

However, this could be changed to a periodic review, meaning the agreement would still undergo assessments regularly but without constantly creating an environment of uncertainty.

3 Dispute Panels

There are currently three chapters in the NAFTA agreement which focus on resolving disputes. The US wants to scrap Chapter 19 which deals with countervailing duties and anti-dumping making sure that certain duties are being applied fairly.

They want to make Chapter 11, which deals with investor-state dispute settlements, optional. This allows investors to sue the government if they bring in new laws or regulations that could reduce profit. The chapter the US is happy to keep is chapter 20 which deals with disputes over NAFTA's interpretation.

These proposals would bring more dispute resolution into US courts and away from international panels. There are suggestions that a possible trade-off could take place where 11 is watered down and parts of 19 kept but also suggestions that Canada and Mexico will make a deal to keep the panels.

4 Government procurement

Government Procurement is still a thorny issue. Despite the US population trumping Canada and Mexico in terms of size, the US wants to cap the combined value of government contracts available to Canada and Mexico at the value of what those countries have awarded to US firms.

It is unclear which way this issue will go.

5 Agricultural laws and elimination of unfair subsidies

The US has proposed taking apart Canada's quota and tariff systems for dairy and poultry, limiting imports and setting fixed prices in the agricultural sector, as well as proposing a measure that would make it easier for US farmers to hit Mexican fruit growers with anti-dumping cases.

This measure for Mexico is unlikely to succeed. However, Canada has given up parts of its dairy market before so it is possible that they could do this again, but so far they have not shown signs of doing so.

What does this all mean for the Bank of Canada?

NAFTA and the threat of US tariffs on steel and aluminium have forced the Canadian central bank to take a 'wait-and-see' approach to monetary policy. But when the NAFTA storm does blow over, we expect the Bank to continue its tightening cycle in the second half of 2018.

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