NAFTA: Perspectives and impact

Renegotiating the North American Free-Trade Agreement (NAFTA) between the US, Canada and Mexico is becoming increasingly problematic as we head into round five in November.

The prospect of ‘no agreement’ and a potential termination of the agreement are moving the radar of investors as the atmospherics around the talks deteriorate.

In our view, terminating NAFTA – driven by US withdrawal – is an increasingly likely scenario over the coming months. However, the innate unpredictability of President Trump leads us to have wide confidence bands around forecasts here.

We see many echoes of the problems between the UK and the EU over Brexit.

Below we outline the key takeaways from each side of the negotiations:

Market Insight

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The Canadian perspective

- A number of the demands the Trump administration are making are no goes for both Mexico and Canada: higher US content rules of origin in auto imports, a 5-year sunset clause on the agreement and, in particular, eliminating parts of the dispute resolution mechanism (this echoes the UK’s objections to any involvement of the European Court of Justice in Brexit negotiations).
- The breakdown of the most recent talks (fourth round) and delay in further progress was partly designed by the Canadians and Mexicans to allow more

time for those negatively affected by NAFTA withdrawal in the US to increase lobbying pressure (this proved effective earlier in the year, but with the Trump administration position so aggressive, hopes for this working similarly are now lower).

- The general view from Ottawa is that the NAFTA renegotiation is primarily focused on preventing the further relocation of manufacturing production to Mexico, and they (Canada) are collateral damage in this process. Recent days have seen US negotiators become more explicit on this point, hence the more strongly worded responses from Canada/Mexico.
- It is unlikely that Canada or Mexico would themselves terminate NAFTA, leaving it to President Trump to take responsibility for ending the agreement.
- It would be an open question whether the pre-existing US/Canada Free Trade Agreement would apply post-NAFTA, or there would be a reversion to WTO terms.

The US perspective

- President Trump has a multi-decade history of consistently criticising US trade deals. Opposition to the current NAFTA agreement was a key focus of his election campaign.

Source: Twitter

- NAFTA is not a priority for Congress – we struggle to see a Republican Congress foregoing tax cuts in an election year (midterms) to save Mexican jobs. The debate over the Budget, tax reform and tax cuts is taking up almost all of Congress' bandwidth at present (a two-thirds majority in both chambers of Congress would be required to override the President's authority to cancel the agreement).
- There is scepticism in Washington DC that US domestic lobbying or concerns about populist 'Chavez 2.0' being elected in Mexico will be successful in swaying an administration which is very trade/economic focused, broadly excluding other issues. There are varying theories of how Congress could block or delay a termination, but it is unlikely that Congress will prioritise this issue.

The Mexican perspective

- Mexican officials expect NAFTA talks to reach a difficult stage, but are still hopeful that the technical basis for discussion will prevail and there could be a path to a win-win outcome. Having said that, they are making contingencies for the impasse and a US withdrawal in which there would be a reversion to WTO-based trading.

- The Mexicans believe that their manufacturing competitiveness and locations are enduring advantages under any trade regime, and that the US beneficiaries from NAFTA will increasingly be heard as talks progress. Failing that, the current government proposes enshrining NAFTA investment protection measures in Mexican legislation to safeguard US investment.

Endgame and market impact

- For the time being, we don't think this upsets the positive outlook for US equities/negative view on US rates, but a sense of a more generalised move to implementing – rather than just talking about – protectionist policies in the US could stress global markets.
- The risks to the Mexican peso are for a move back towards the lows of the year – the sharp downward moves of the British pound last year on Brexit concerns are a good roadmap.
- Shorter-term risks for Mexican assets could be amplified by the left-wing populism movement, with the Morena party benefiting from a sense of 'anti-Mexican' actions in the US.
- The medium-term growth impact for Mexico could be negative – but tariffs alone can be offset by relative price adjustments with the FX rate playing the major role. The more problematic near-term aspect is the risk that inward investment dries up in the face of added uncertainty over future trading relationships.
- The impact on Canada is also likely to be negative, but not greater than the Canadian dollar fluctuations around oil price moves have impacted the manufacturing sector. It may well add to the reasons for the Bank of Canada to be cautious on further interest rate hikes and, at the margin, weaken the Canadian dollar.
- EU/Asian governments are watching this situation very closely due to concerns over a broader US approach to the WTO and other multilateral deals.