NAFTA 2.0: Compromise within reach

- We believe that compromise is within reach in the NAFTA renegotiation process, despite the thorniest demands of the U.S. negotiation team.

- In the dispute settlement, the road to compromise will likely be paved by a reform of the investor-versus-state mechanism (Chapter 11) and the elimination of the “global safeguard exclusion” provision.

- Regarding rules of origin, although Mexico and Canada are unlikely to give in to the demand for a (previously inexistent) 50% U.S. content requirement, there is greater flexibility to increase regional content at the expense of suppliers from the rest of the world.

- We believe that there will be a moderation in the U.S. demand to impose seasonal windows on agricultural goods as one of Mexico’s strongest allies (the U.S. Agriculture sector) weighs in. Moreover, the U.S. government seems to be taking a step back on the sunset clause proposal, perhaps along the lines of Mexico’s counterproposal (i.e., periodical reviews without the threat of undoing the agreement).

- While our base case is that a NAFTA deal will be reached during 1H18, talks are likely to overlap with Mexico’s presidential campaign season, potentially adding noise to the renegotiation process.

We believe that compromise is within reach in the NAFTA renegotiation process. Although there are polemic issues yet to be agreed upon – which include the dispute settlement, rules of origin, seasonal windows for agriculture, the sunset clause, public procurement and Canada’s supply-chain-management system – we attempt to detail how such a compromise can be reached and why it is our base-case scenario.

In the dispute settlement, the road to compromise will likely be paved by a reform of the investor-versus-state mechanism (Chapter 11) and the elimination of the “global safeguard exclusion” provision. Both of these are explicit U.S. demands, and Mexico has hinted that it might be willing to give in (at least on Chapter 11). In a nutshell, NAFTA’s Chapter 11 contains an investor-versus-state dispute settlement mechanism whereby private investors can individually bring cases to arbitration panels and obtain retroactive compensation – unlike the WTO framework, where all disputes are state-versus-state, implying a more bureaucratic process, and compensation is only prospective\(^1\). The U.S.’s position is that Chapter 11 allows foreign investors to bypass U.S. laws and should therefore become optional through a new “opt-in, opt-out” clause. With this proposed clause, if a private party submits an arbitration claim within the NAFTA framework, the defendant (government of the U.S., Mexico or Canada) would have the option to take part in the arbitration process (opt-in) or refuse to participate (opt-out). If a country’s government opts out, then the private party would have to appeal to the local court system of the country in question. The arbitration process is currently mandatory (governments cannot refuse to participate). Mexico’s negotiators recently expressed that Chapter 11 could apply only to Mexico and Canada,

\(^1\) In theory, WTO dispute settlement also offers the possibility of retroactive compensation as long as the litigating parties agree on the amount of the compensation within 20 days of the decision. However – as stressed by Hufbauer and Schott (2005) – this seldom happens and, instead, trade retaliation (authorized by the WTO’s Dispute Settlement Understanding’s Article 22) is normally the final result. See page 221 in Hufbauer and Schott (2005), “NAFTA Revisited: Achievements and Challenges”, Institute for International Economics. Of course, retaliation causes more collateral damage than lump-sum compensation.
thereby implicitly accepting the U.S. demand to opt out. Moreover, at the closing of the 6th round – held in Montreal on January 21-29 – Canadian media pointed out that Canada and Mexico have similar positions on the ideas to reform Chapter 11.

The “global safeguard exclusion” curtails governments’ ability to protect domestic industries, so the U.S. team is requesting its elimination (and we believe that Mexico will come around). The U.S.’s recent decision to impose global safeguards on washing machines and solar panels is mainly targeted at China and Korea, but it also affects Mexico and Canada. According to the “global safeguard exclusion” provision, imports from NAFTA countries are exempted from global safeguards unless: i) they account for a substantial share (top five suppliers) of the imported good; or ii) they significantly hinder the domestic industry. In any case, if a NAFTA country implements global safeguards, it is automatically obligated to provide “mutually agreed trade liberalizing compensation” to its NAFTA counterparts (or face retaliatory actions). Mexican firms can currently challenge the U.S. safeguards through Chapter 11 (initiating an investor-versus-state case, many of which have focused on trade disputes in the past); the Mexican government could also do the same through Chapter 20 (state-versus-state).

A considerable concession on the dispute-settlement front would be to fully remove the restrictions on safeguards, which are actually a legitimate trade policy instrument used worldwide. In fact, eliminating the “global safeguard exclusion” would not only be compliant with WTO law, but it would also give the U.S. greater discretion to protect its local industries (which is precisely what President Trump wants) and preserve Chapter 19 (which is the most valued aspect of dispute settlement for both Mexico and Canada, the true “red line” of the Canadians). We note that Chapter 19, the third leg of NAFTA’s dispute settlement tripod system (chapters 11, 19, 20), establishes five-member bi-national panels of international trade law experts (two designated by each litigant country and the fifth elected by the panelists) to review anti-dumping and countervailing duties (AD/CVD) imposed by the U.S., Canada and Mexico. The panel rulings have the power to overturn decisions and force countries to refund the AD/CVD (unlike WTO cases, which offer no refund). This is a unique feature of NAFTA, to be sure, given that no other agreement in the world holds AD/CVD country decisions to such accountability.

Regarding the rules of origin, Mexico recently expressed a greater willingness to accommodate U.S. demands and Canada has tabled new ideas. The U.S. is requesting an increase in regional content in the Automobile sector, to 85% from 62.5%, and the creation of a previously inexistent U.S. content requirement of 50% – a demand that, at the outset, was rejected by Mexico and Canada. The guidance has nevertheless changed substantially in 2018. Mexico’s team now acknowledges that any solution to the rules-of-origin impasse will imply a strengthened regional content rule, and the U.S. team has welcomed this by stating that “some real headway” was made at the 6th round in Montreal. Even though giving in to the demand of the 50% U.S. content requirement is unlikely, there seems to be greater flexibility to increase regional content at the expense of suppliers from the rest of the world (mainly Asia).

We believe that there will be a moderation in the U.S. demand to impose seasonal windows for agricultural goods as one of Mexico’s strongest allies (the U.S. Agriculture sector) weighs in. The U.S. is demanding that tariff-free access to the U.S. market for 61 agricultural goods be restricted to a time of year when there is no local production/harvest. The mechanism to achieve this goal, as per the U.S. proposal, would be to create special rules for the implementation of anti-dumping duties (imposed when a foreign firm exports at below-cost) and countervailing duties (imposed when foreign exports are subsidized) on the abovementioned 61 agricultural goods. To determine whether AD/CVD are justified, agricultural imports are currently evaluated on the basis of a time

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period (year) and geography (country). The proposal is to change the criteria from year to season and from country to region. Given the strong seasonality of agricultural prices, analyzing shorter time periods and smaller geographies would result in many more occasions when export prices are apparently too low (making them an easier target for AD/CVD actions). As reported by the media, this is an initiative by Florida fruit growers, while the vast majority of the U.S. Agriculture sector is overwhelmingly pro-NAFTA.

**The U.S. seems to be taking a step back on the sunset-clause proposal.** On November 18, the USTR updated the “Summary of U.S. negotiation objectives” (earlier version, July 17), from which we draw signs of moderation. First, the demand for the sunset clause is now worded as “assess the benefits of NAFTA on a periodic basis,” rather than “renegotiate or terminate every five years”, as it was presented in the 4th round in October. In November, Mexico actually presented a counter-proposal along these lines: revise without the threat of undoing the agreement – which Canada later seconded.

**There are two other controversial negotiation issues that are less relevant for Mexico: Canadian supply-chain management and public procurement.** The Canadian supply-chain-management system offers protection to local dairy and poultry producers by limiting imports and organizing domestic production. It is an exception carved into NAFTA, just like Mexico was allowed to keep its monopoly in the Energy sector. The U.S. is demanding that Canada liberalize this market. Turning to public procurement, the U.S. is proposing a new “dollar-per-dollar” rule, which means that the U.S. government could cap its purchases from Canadian and Mexican suppliers at the same level of purchases made by the Canadian and Mexican governments from U.S. suppliers. Firms from both Canada and the U.S. have big stakes in the public-procurement markets, particularly in defense/military contracts.

**Our base case is that a NAFTA deal will be reached during the first half of this year, so talks will likely overlap with Mexico’s presidential campaign season, potentially adding noise to the renegotiation process.** The Mexican Senate will recess in May, but special commissions will continue to operate and could ratify the renegotiated NAFTA agreement anytime until the last day of August 2018 (before the new Congress assumes office on September 1). Looking further ahead, we do not believe that a hypothetical scenario in which the anti-establishment candidate Andrés Manuel López Obrador (AMLO) wins the presidential election would be a death sentence for NAFTA. In fact, AMLO has argued that NAFTA has been important for the development of northern Mexico, and his advisers (and pre-appointed ministerial cabinet members) claim that an AMLO government would work to modernize the trade agreement with its North American neighbors.

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