



NAFTA renegotiation:

What is next after the 4th round?

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- The first three NAFTA negotiating rounds were relatively easy with agreements in less controversial issues for the three parties
- Nevertheless, the fourth round brought to the fore some dissenting opinions
- Our base case continues to be that of a successful negotiation, although our conviction faded given recent events
- Among others, we expect the negotiations to extend beyond December 2017, mingling inevitably with U.S. and Mexico's political processes
- In our view, even in the most negative scenario -U.S. withdraws from the agreement-, there are some issues to consider:
 - (1) Mr. Trump's tweets or statements not necessarily translate into economic policy;
 - (2) There is uncertainty with respect to the withdrawal mechanism in the U.S.; and
 - (3) We do not necessarily think that this would be a catastrophic backdrop for Mexico in the medium and long-term, albeit with a highly volatile adjustment period
- Nevertheless, we do expect volatility in financial markets in the short-term



NAFTA renegotiation: What is next after the 4th round?

The fourth round of renegotiation of the North American Free Trade Agreement (NAFTA) ended with a less favorable balance compared to previous rounds. Even though the Mexican Minister of Economy, Ildefonso Guajardo, and the Canadian Minister of International Trade, Chrystia Freeland, showed a more cautious tone, they sent a constructive message looking ahead.

Nevertheless, U.S. trade representative, Robert Lighthizer, said that only one of the two targets of the renegotiation has been achieved -update the agreement to a more modern economy-, while in trying to reduce the bilateral deficit he said that he was: “...surprised and disappointed by the resistance to change from our negotiating partners...”.

In our view, the focus of the first three rounds was in issues with common ground. Unfortunately, as it is the case in many negotiations, in the fourth round some disagreements were brought to the fore.

It is worth mentioning that this last process was accompanied with aggressive comments from President Trump, suggesting that NAFTA must end and that they should seek bilateral agreements with Mexico and Canada on a separate basis. In addition, U.S. delegation made some proposals against the spirits of free trade agreements, as it is the case of the so called *sunset clause* by which the agreement could be negotiated every five years.

We expect Mexico's negotiating team to remain at the table and adopt a *strategic patience* attitude. Moreover, we believe that private sector lobbying efforts in the U.S. will pay-off soon, as it was the case with the *Border-Adjusted Tax (BAT)*.

Our base case scenario continues to be that of a successful negotiation and that a modified version of NAFTA will finally be approved. Nevertheless, our level of conviction has faded after recent events.

Renegotiation will take longer than expected. The fifth negotiating round will take place in Mexico at the end of the month (November 17-21), while the rest of them will be delay until early 2018. This implies that it will take more time to wrap up -they expected to be finished by the end of this year-, which inevitably mingles with both U.S. and Mexico's political processes.



In the U.S., negotiations could be complicated by TPA expiration in June and mid-term elections in November. In the first case, the *Trade Promotion Authority* or TPA is a piece of legislation that defines U.S. targets and priorities in a trade negotiation. Moreover, it establishes some consult and notification requirements that the administration must follow. At the end of the negotiation and after the required consultation, Congress votes 'yes' or 'no', without the possibility of amending the government's proposal. Without TPA, the U.S. government can continue with the negotiation but if they want to pass it through Congress, it should follow the normal procedure, *i.e.* it could be subject to amendments and changes, as well as more time to be passed. So TPA is one of many ways in which Congress gives the Executive the power to exercise Congress' authority over trade policy. TPA gives the president more leverage to negotiate as its counterparts have confidence in that what they have agreed on, will be approved.

TPA implications

	Without TPA	With TPA
The President can make negotiate trade agreements	Yes	Yes
President can keep Congress and public in the dark	Yes	No
Congress directs negotiating targets	No	Yes
Members of Congress entitled to read negotiating text	No	Yes
Administration required to publish updated summaries throughout negotiations	No	Yes
Administration must make text of Trade Agreement public for 60 days before consenting	No	Yes
Congress can make amendments to the text	Yes	No

Source: Banorte with data from www.byrne.house.gov

Mid-term elections. On November 6th, 2018, the House of Representatives will renew all its 435 seats, along with 33 out of 100 seats in the Senate. Moreover, there will be elections in 39 states. These processes are relevant because it could change the balance between Republicans -that have a majority in both houses (52 out of 100 in the Senate and 240 out of 435 in the House of Representatives)-, and democrats while it is also viewed as a validation of Trump's administration. If NAFTA negotiations are extended, they could overlap with mid-term elections, with Congress leaving the discussions for after the election.

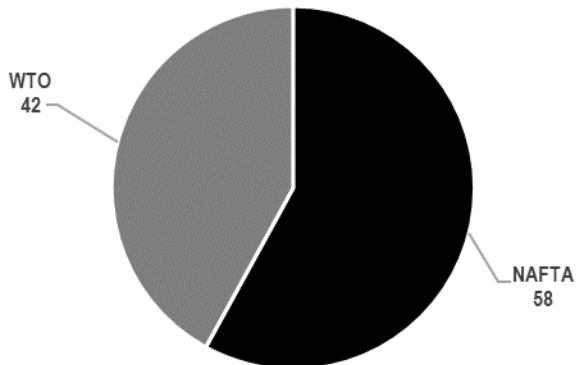
Elections in Mexico. Longer-than-expected NAFTA negotiations could complicate approval process by Congress in Mexico. Once a text is agreed upon, there is a 90-day period for consultation. Recess in the Mexican Congress start in May, with very low probability of a call for an extraordinary session given the proximity of election day. This implies that the agreement should be ready at the beginning of next year to be approved before the election.

In our opinion, even in the most negative scenario -a U.S. withdrawal of the agreement-, there are some issues to consider: (1) Mr. Trump's tweets or statements do not necessarily translate into economic policy; (2) there is uncertainty with respect to the withdrawal mechanism in the U.S.; (3) we do not necessarily think that this would be a catastrophic backdrop for Mexico in the medium and long-term.

- (1) Mr. Trump's tweets or statements do not necessarily translate into economic policy.** It is well known Mr. Trump's inclination to make statements via *Twitter*. In fact, just in the first 6-months of his administration, he has *tweeted* more than a thousand times. In addition, he has signed a dozen of executive orders, although most of them have not been translated into law, in particularly those related to his infrastructure plan, fiscal reform or the *Obamacare*. This implies that any tweet or executive order with respect to NAFTA could cause volatility in markets, but will be transitory, in the absence of other measures to make it happen.
- (2) There is uncertainty with respect to the withdrawal mechanism in the U.S.** There is some debate over the President's leeway to unilaterally make the decision of withdrawing from NAFTA. While it is true that the Constitution grants to Congress the faculty of conducting trade policy, this has been traditionally delegated in the executive power. In this context, President Trump could invoke NAFTA's article of withdrawal, triggering the 6-month period for exiting contained in that article. This could eventually end up in the Supreme Court, who could probably rule in favor of the President. Nevertheless, to implement NAFTA, the U.S. Congress passed the HR 3450 *North American Free Trade Agreement Implementation Act*. Even if the President withdraws from NAFTA, Congress must revoke this piece of legislation.
- (3) We do not necessarily think that this would be a catastrophic backdrop for Mexico in the medium and long-term.** The agreement will still be valid for the other two countries while MFN tariffs will be in place. Moreover, companies based in Mexico that want to export goods to the US can do it using the *Nafta window* -paying zero tariff, if these companies fulfill the requisites-, or via the *WTO window*, paying the corresponding tariff. Sometimes, for example, a firm that exports cars to the US does not comply with the 62.5% rule of regional North America content. This might be because of transitory logistical issues, such as having to import more auto parts from Europe. As a result, they do not reach the minimum of 62.5% and this does not mean that they cannot export it to the US or Canada. It is fairly simple: this company uses the *WTO window* and pays a quite low tariff (US most favored nation *WTO* tariff averages 3.5%). In fact, 42% of the goods that Mexico exports to the US do not even use the *Nafta window*. All in all, there is no doubt that there will be winners and losers due to a potential US exit of NAFTA, but commercial activity between Mexico and the US is not going to change significantly (see chart below).

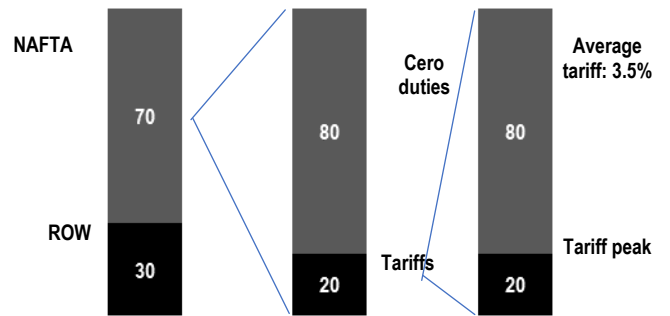
In addition, even though 70% of Mexican exports go to the U.S., 80% of them pay zero duties, while the rest has different tariffs. From this amount (14% of total exports), 80% pays an average tariff of 3.5% while the rest is subject to higher tariffs. These numbers imply that only 4% of our exports would be paying the tariff peak, as shown in the chart below on the right.

Exportaciones a EE.UU. por vía de exportación
% del total



Source: Banorte with data from the US Census

Porcentaje de exportaciones a América del Norte por tipo de arancel
%



Source: Banorte with data from Ministry of Economy

Nevertheless, in the short term, we expect a highly volatile period of adjustment. In any of the scenarios presented, we expect market volatility in the short-term. We expect the main shock-absorber to be the FX, with the consequences on inflation and growth expectations for next year. In our view, the Mexican economy is resilient enough to weather the shock with solid macroeconomic fundamentals, which include an autonomous central bank, healthy public finances, along with other economic policy tools. Even rating agencies have recognize a solid fiscal position, with S&P and Fitch changing their outlook for the country's credit rating to 'stable' from 'negative' in recent months. In addition, the Exchange Rate Commission has announced an increase in the amount of non-deliverable forward auctions, amid increased levels of volatility after the end of the fourth round of negotiations. In terms of growth, we expect U.S. withdrawal from NAFTA to make a dent on investment and consumption levels, while net exports could actually have a positive contribution to GDP. Finally, we consider that the impact on inflation would be limited, in particularly given that exchange rate pass-through has been relatively low and given that demand would actually soften.

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