Potential withdrawal from the North American Free Trade Agreement

One of the principal losers in the recent presidential election in the United States of America (U.S.) was undoubtedly the North American Free Trade Agreement (NAFTA). Its economic benefits minimized or overlooked and its imperfections and unfulfilled promises exaggerated, it was subject to a successful but very unfair demonization.

The threat is latent of an eventual withdrawal from NAFTA by the U.S. if it is found impossible to renegotiate its terms. It remains to be seen if such withdrawal is a real possibility or is only a "campaign promise"; nevertheless, certain recent events indicate that a renegotiation will be formally requested although its scope is uncertain.

A withdrawal from NAFTA by the U.S. would be a mistake, with adverse economic effects for both Mexico and the U.S., the significance of which, once evaluated in detail, should be sufficient to dissuade any potential withdrawal. The reasons we make this assessment are the following:

A. THE PREMISES FOR REQUESTING A RENEGOTIATION ARE FALSE OR EXAGGERATED.

During the recent presidential campaign in the U.S., NAFTA was systematically accused of being the direct cause of: (i) unemployment in the U.S. and (ii) "unfair" trade resulting in a U.S. trade deficit with Mexico.

Nothing is farther from the truth. While NAFTA came up short as a generator of a significant number of jobs in the U.S., it is estimated that there are currently in that country more than 6 million jobs directly related to the activity of exporting goods in which NAFTA plays an essential role.

Furthermore, it is estimated that since 1994, NAFTA has generated up to 700 thousand jobs in Mexico. This means that the current level of unemployment in the U.S. is the result of many factors other than NAFTA, which include the high cost of labor in the U.S., the automation of North American production plants and more importantly the migration of a considerable number of production plants to China, South Korea, Japan and other countries.

In relation to the U.S. trade deficit with Mexico, it represents only 7% of the global trade deficit of the U.S. More than 40% of such deficit is with China, which country does represent a real commercial problem for the U.S.

Finally, the U.S. trade deficit with Mexico has a logic reflected in the inter-industrial market of intermediate products between the two countries, which products in many cases are exported from the U.S. to Mexico for their transformation and then returned to the U.S. to be used in export products.

We hope that any round of subsequent renegotiations makes clear that the structural economic deficiencies of the U.S. do not originate from NAFTA and will not be resolved by withdrawing from it.

B. EFFECTS OF A POTENTIAL WITHDRAWAL.

Article 2205 of NAFTA permits any of the signatory parties to withdraw from NAFTA, which will take effect 6 months after giving notice to the other parties of its intention to withdraw. According to unofficial documents, the U.S. would notify its intention to withdraw from NAFTA after 200 days have passed from the initiation of the new administration if Mexico and Canada have not agreed to renegotiate it.

In the case of a withdrawal from NAFTA by the U.S. in the above indicated terms, which would take effect at the beginning of 2018, the commercial relations among the U.S., Canada and Mexico would have to be governed by the guidelines of the World Trade Organization (WTO). So far there has not been any indication of a possible withdrawal from that instrument, nor is it expected given the importance it has for the U.S.

In the scenario of a withdrawal from NAFTA and under the guidelines of the WTO two relevant phenomena would be present. First of all, the imports into the U.S. of products from Mexico would be subject to a relatively low Most Favored Nation (MFN) tariff that would still make it viable to maintain production in Mexico based on lower costs in Mexico. However, that import tariff into the U.S. could affect the competitiveness of the production plants located in such country.

On the other hand, the imports into Mexico of products from the U.S. would be, in the majority of cases, subject to a somewhat higher MFN tariff, affecting the production in the U.S. In fact, U.S. agricultural products would be severely affected since they would be taxed with an entry tariff into Mexico of up to 38%.

C. VIOLATIONS OF THE OBLIGATIONS UNDERTAKEN BY THE U.S. UNDER THE WTO.

One of the recurring promises of the election campaign was to impose tariffs of 35% on the import into the U.S. of certain products prepared or produced in Mexico and in other countries, theoretically in order to encourage the reestablishment of production plants in the U.S.

In this regard and in the case of a possible withdrawal from NAFTA, there is a high possibility that the establishment of a tariff of that magnitude would imply a violation by the U.S. of its obligations under the WTO. This possible violation would allow Mexico to establish certain retaliatory tariffs or other measures having an equivalent effect.

In the past, Mexico has not hesitated in established retaliatory tariffs on the import ofU.S. products when faced with the refusal of that country to voluntarily correct measures declared to be in violation of its international commitments. The retaliatory tariffs imposed by the Mexican Government during the years 2009 and 2010 which were decisive in the final resolution of certain commercial disputes confirm this.

Currently, Mexico has the information and instruments necessary to legally "surgically" punish the production of U.S. merchandise taking into consideration not only its importance or volume of export but also whether the state of production is Republican or not.

Regardless of the campaign promises, this and other elements would have to be taken into consideration for decision making relative to the adoption of protectionist measures.

D. REALITIES OF NAFTA

NAFTA has generated, among other things, a profound integration among the U.S., Canadian and Mexican markets that would be very difficult to reverse. While NAFTA is not perfect, it has generated multiple benefits and advantages for the U.S. that necessarily would have to be recognized and evaluated in any responsible decision making. The following are some of those benefits:

1. Although NAFTA did not result in the expected level of job generation in the U.S. –due to the rise of China- it has generated a significant number of well-paid jobs related to the export market.
2. The efficiency and low costs resulting from operating in Mexico have translated into greater global competitiveness of the U.S. parent companies and this has allowed them to successfully compete with companies in other countries.
3. NAFTA has generated an extremely solid and efficient regional automotive industry. The various regional value chains are now fully integrated. A significant number of vehicles sold globally have been produced in the NAFTA region.
4. NAFTA has provided U.S. production plants with high quality intermediate goods at low cost. This supply of goods is not limited to the automotive industry but extends to many different sectors: power, pharmaceutical, food, aerospace, etc.
5. It has provided the final consumer in the U.S. with quality goods at competitive prices. The elimination of NAFTA and the imposition of a tariff on the import of products into the U.S. would generate an increase in prices on those products with the consequent adverse implications in the economic sphere.

E. CONCLUSIONS

1. The "adverse" effects of NAFTA for the U.S. were exaggerated but effectively sold to the U.S. electorate. There is a mistaken perception that NAFTA is the principal cause of many of the economic problems of the U.S.
2. Recently filtered information indicates that serious consideration is being given to implementing many of the campaign promises. However, it is possible that talk of this supposed implementation is primarily for propaganda purposes.
3. The application and operation of NAFTA has provided various competitive and strategic advantages to the U.S., the elimination of which would have an enormous impact on the competitiveness of U.S. companies globally, specifically affecting employment.
4. Reason would dictate that keeping those competitive and strategic advantages is necessary for the U.S. economy.
5. In any case, the adoption of protectionist measures would in no way guarantee the relocation to the U.S. of production plants other than those that have a high level of automation.
6. A strong defense for maintaining NAFTA is expected from the large U.S. transnational companies with all their resources and influence in all areas.

To obtain additional information contact our expert:

Luis Miguel Jiménez, Partner:
+ 52 (55) 5258-1058, lmjimenez@vwys.com.mx

Sincerely,

Von Wobeser & Sierra, S.C.

Mexico City, November 18th, 2016.