The End of NAFTA? What Policymakers Should Know

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An analysis of US jobs that rely on exports to Canada and Mexico finds that withdrawing from the North American Free Trade Agreement (NAFTA) would cost 187,000 of those jobs over a 1 to 3 year period. (By comparison, from 2013 to 2015, a total of 7.4 million US workers were displaced, or lost their jobs involuntarily.) The most affected states are Arkansas, Kentucky, Mississippi, and Indiana. The most affected sectors are autos, agriculture, and manufacturing (non-auto).

These estimates are based on the latest available World Trade Organization’s (WTO) most favored nation (MFN) tariff rates that would apply to US exports without NAFTA—and the fact that higher prices of US-made or grown exports will dampen sales to Canadian and Mexican consumers. The analysis assumes that firms would then cut production, leading to US job displacements. These estimates do not take into account the potential disruptive impact on supply chains from an elimination of NAFTA.
### IMPACT BY INDUSTRY

<table>
<thead>
<tr>
<th>Industry</th>
<th>Percent of jobs displaced</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto</td>
<td>0.51%</td>
</tr>
<tr>
<td>Agriculture</td>
<td>0.45%</td>
</tr>
<tr>
<td>Manufacturing (non-auto)</td>
<td>0.30%</td>
</tr>
<tr>
<td>Trade</td>
<td>0.22%</td>
</tr>
<tr>
<td>Transportation</td>
<td>0.18%</td>
</tr>
<tr>
<td>Utilities</td>
<td>0.16%</td>
</tr>
<tr>
<td>Mining</td>
<td>0.15%</td>
</tr>
<tr>
<td>Services</td>
<td>0.12%</td>
</tr>
<tr>
<td>Construction</td>
<td>0.01%</td>
</tr>
</tbody>
</table>

### MOST AFFECTED COUNTIES

<table>
<thead>
<tr>
<th>County</th>
<th>Estimated Job Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scott County, MS</td>
<td>222 out of 11,711</td>
</tr>
<tr>
<td>Murray County, GA</td>
<td>128 out of 8,098</td>
</tr>
<tr>
<td>Knox County, MO</td>
<td>19 out of 1,229</td>
</tr>
<tr>
<td>Hardy County, WV</td>
<td>64 out of 4,873</td>
</tr>
<tr>
<td>Bolivar County, MS</td>
<td>117 out of 9,287</td>
</tr>
<tr>
<td>Marshall County, AL</td>
<td>344 out of 30,251</td>
</tr>
<tr>
<td>Macon County, IL</td>
<td>485 out of 43,503</td>
</tr>
<tr>
<td>Whitfield County, GA</td>
<td>516 out of 46,877</td>
</tr>
<tr>
<td>Harris County, GA</td>
<td>49 out of 4,570</td>
</tr>
<tr>
<td>McDonald County, MO</td>
<td>62 out of 5,865</td>
</tr>
</tbody>
</table>
SUPPLY CHAINS, ECONOMIC INTEGRATION, AND MANUFACTURING

Social Media Graphic The US-Mexico-Canada Economies Are Tied Together

The US-Mexico-Canada economies are tied together
Percent real GDP growth of NAFTA countries, 1993–2015 (latest available)

Why Renegotiating NAFTA Could Disrupt Supply Chains
By Mary Amiti (Federal Reserve Bank of New York), Caroline Freund, and Tyler Bodine-Smith (Federal Reserve Bank of New York)

Supply chains have become increasingly interlinked across the US-Mexico border. The North American Free Trade Agreement (NAFTA), allowing tariff-free commerce between the United States, Canada, and Mexico, has facilitated this integration. Some critics of NAFTA are concerned about the bilateral trade deficit and have proposed stricter rules of origin (ROO), which would make it more cumbersome for firms to access the zero tariff rates they are entitled to under NAFTA. We argue that measures that make it costlier for US firms to import will also hurt US exports because much of US-Mexican trade is part of global supply chains.

The existing fragmentation of production in NAFTA reduces production costs by providing low-cost intermediate inputs to US firms. Lower production costs mean domestic consumer prices and the cost of US exports are also pared down. Thus US exports are boosted because US companies are more competitive.

In order to be eligible for duty-free imports under NAFTA, member countries must abide by rules of origin, which detail the conditions under which a product qualifies for NAFTA preferences. These rules are complex, applied on a product-by-product basis, and include requirements to ensure there is sufficient value added within the member countries. Tightening rules of origin, which effectively raises the cost of trade, is unlikely to increase trade or lower the trade deficit but is very likely to disrupt supply chains.
SUPPLY CHAINS DOMINATE US-MEXICAN TRADE UNDER NAFTA

Mexico is a top US trade partner, especially important for supply chain trade. Mexico accounts for about 14 percent of both US exports and imports. A large share of US trade with the world, and especially with Mexico, is part of global supply chains, where one input is produced in one part of the world, then shipped on to another country, and so on. Because the factory is now global, the same product can be shipped back and forth across the same borders multiple times.

The importance of US-Mexico supply chain trade is shown in the table below, which presents aggregate statistics on US trade. Forty percent of imports from Mexico and 75 percent of exports to Mexico are in intermediate inputs, at least as high as the world average. These products, like auto parts or computer components, are used to produce final goods. In addition, a great deal of the trade takes place within firms, as demonstrated by the high shares of related-party trade (trade within firms with at least 10 percent ownership in the trading partner) and affiliate trade. Firms such as General Motors and Ford send auto parts back and forth across the border as cars are produced, using a regional supply chain, which makes production more efficient, lowers the cost of cars to the consumer, and makes firms more globally competitive. If it becomes costlier to access intermediate inputs, this can cascade down many stages of the production chain and disrupt the production of the final good. These trading relationships are particularly important in the auto industry, which accounts for 60 percent of majority-owned affiliate trade.

### Share of US trade in goods

<table>
<thead>
<tr>
<th></th>
<th>US imports from</th>
<th>US exports to</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mexico</td>
<td>All countries</td>
</tr>
<tr>
<td>Intermediate input</td>
<td>40%</td>
<td>45%</td>
</tr>
<tr>
<td>Related-party trade</td>
<td>67%</td>
<td>51%</td>
</tr>
<tr>
<td>Majority-owned</td>
<td>21%</td>
<td>16%</td>
</tr>
<tr>
<td>affiliate trade</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Related-party trade is defined as trade within firms with at least 10 percent ownership in the trading partner.

Sources: US Census Bureau, Bureau of Economic Analysis.

The cross-industry variation can be seen in the chart below, where the blue bars depict the share of each industry in total US imports from Mexico and the gray bars are the US export shares to Mexico. US production and consumption depend heavily on imports of transport and electrical equipment from Mexico, while Mexico is especially dependent on imports of chemicals from the United States.

The darker shaded parts of each bar depict the related-party share. The high shares of related-party trade in transport, electrical, and machinery highlight the importance of global supply chains in these industries.
SUPPLY CHAINS SUPPORT US EXPORTS

Low-cost inputs from Mexico help US producers compete efficiently in global markets. The US industries most heavily dependent on imported inputs from Mexico can be identified using input-output tables. The table below shows that ten (out of 205) industries obtain more than 10 percent of their total intermediate inputs from Mexico. For example, for audio/video manufacturing, 18 percent of total inputs come from Mexico—that amounts to a third of all the imported inputs used by that industry. Most of these audio/video products are destined for the export market, with half going to Mexico. In other examples of products with a high imported input content, like dental equipment, the product is mostly for US domestic consumption, where imported parts help lower production costs and hence prices. This illustrates the interconnectivity of trade. These ten industries alone account for 10 percent of total US exports. Any policies that would make it more costly to import these inputs, for example, through higher border taxes or tougher rules of origin, would hurt not only US imports but also US exports.
GLOBAL SUPPLY CHAINS AND THE TRADE BALANCE

It is common for a large developed country like the United States to have a trade deficit with the low-cost supplier in its production chain. As shown above, US producers benefit from importing parts from Mexico and building high-quality goods, some of which are consumed locally and some of which are exported. The deficit with Mexico is like the deficit of any large company with its suppliers; the company purchases inputs but sells little to these smaller firms.

Bilateral deficits matter little for the aggregate trade balance. For example, Germany, despite running a large aggregate trade surplus, runs bilateral trade deficits with the Czech Republic, Slovakia, and Hungary, the main low-cost suppliers in the European production chain. Consider autos, where the Czech Republic is the largest supplier to Germany. The chart below shows the trade balance relative to total trade in the transport sector (HS87) for the United States with Mexico and Germany with the Czech Republic, where year zero is the implementation of the respective trade agreements (1994 for NAFTA and 2004 for EU accession). As supply chains have developed, trade imbalances in the sector expanded, contributing to the increasing competitiveness of US and German manufacturers.
The End of NAFTA? What Policymakers Should Know

NAFTA ALREADY HAS STRICT RULES OF ORIGIN

The extensive supply chains in NAFTA have developed around the existing rules of origin, which grant duty-free access only to locally produced or transformed goods. ROO are used in all free trade agreements because the applied tariffs of member countries differ. Without ROO, products could be imported into a member country with the lowest tariff and then exported to a higher-tariff member country under preferences, thus escaping the duties. While rules of origin are allowed to protect against this so-called trade deflection, they should not be used to distort international trade according to international rules.

Despite World Trade Organization guidelines, rules of origin are sometimes designed to protect special industries. For example, an auto must contain 62.5 percent NAFTA content to bypass member-country tariffs. While retaining a high share of value added in the North American supply chain has benefits, it also has costs. Companies are required to maintain extensive spreadsheets recording the origin and value of all parts at the plant level, even sometimes breaking individual parts down into the share that is local. Keeping tabs on origin is time-consuming, especially when parts are sourced from multiple suppliers. It also means companies sometimes use more expensive local parts to qualify for NAFTA preferences. Additional complications arise from overlapping trade agreements and rules of origin. Some products that qualify for special treatment in one market may need to be altered to qualify as local in another market. For all these reasons, international rules stipulate that ROO must be transparent and predictable.

NAFTA already has relatively strict rules of origin. Research comparing eight types of free trade agreements, including pan-European pacts, finds that NAFTA has the strictest and most complex rules of origin. Because it is costly and time-consuming for companies to adhere to rules, preferences are not always utilized. Across more than 3,500 products imported from Mexico that have positive most-favored nation (MFN) tariffs, on average 20
percent enter the United States without taking advantage of preferences.

If rules are strengthened, more imports are likely to enter both the United States and Mexico without using NAFTA preferences. Many parts and components now crossing the border duty free would instead cross under MFN tariffs but without adhering to the ROO. Once preferences are not utilized, it no longer matters where products come from—local content becomes irrelevant. Thus, some intermediate inputs will simply be imported from countries outside NAFTA. Stricter rules can thus perversely result in lower local content. Because a change in rules would affect trade on both sides of the supply chain, it is unclear what would happen to the bilateral deficit.

Strengthening rules of origin does not guarantee that the bilateral trade deficit will fall, though by raising the cost of trading across borders, stricter rules are likely to reduce trade and increase supply chain disruption.

Video **Toughening NAFTA’s Rules of Origin Could Backfire**

This short video explains how NAFTA's rules of origin work and why tightening them may actually result in less North American content and no new American jobs.
A US Content Requirement in NAFTA Could Hurt Manufacturing

By Caroline Freund

The US administration is reportedly considering adding a US-specific content requirement for vehicles imported through the North American Free Trade Agreement (NAFTA). The proposal would require vehicles to have 35 to 50 percent US content to qualify for duty-free access under the agreement.

Country-specific content rules hark back to the 1965 Canada-US Auto Pact, which liberalized regional auto trade, provided Canadian content requirements were met. The Canadian regime under the pact was later ruled illegal under international rules.

While the Canada-US Auto Pact boosted Canadian production, it was a liberalizing agreement that allowed auto companies to take advantage of scale economies. In contrast, adding US content requirements to NAFTA would create a more restrictive trading environment that would hurt competitiveness.

Because US content requirements would result in a less competitive industry, they would likely lower North American production and fail to promote US manufacturing. In particular, country-specific rules could cause trade to take place outside of NAFTA preferences or cause foreign companies to leave North America and export from their home regions, where US content is much lower. Domestic content requirements could also be challenged under international rules.

COUNTRY-SPECIFIC CONTENT REQUIREMENTS DATE TO THE AUTO PACT

NAFTA grants duty-free access to producers in Canada and Mexico, provided goods are made in those countries. Currently, rules of origin are used to ensure that goods produced in countries outside the region are not entitled to duty-free access. For example, the current rule for cars requires that 62.5 percent of the value of an imported vehicle must originate in Canada, Mexico, or the United States to be eligible for zero duties.

A country-specific content requirement would mean that cars produced in Mexico or Canada, with mostly domestic parts and labor, would no longer be eligible for duty-free access. Refusing a Mexican or Canadian made vehicle duty-free access contradicts the aim of a free trade agreement (FTA) and is not observed in any other FTA around the world.

It would not be entirely unprecedented, however, especially in autos. The 1965 Canada-US Auto Pact required a high share of Canadian content for companies to benefit from duty free access. Companies operating in Canada could export vehicles and parts to Canada duty-free, provided they produced one car in Canada for each one sold there and that Canadian content in domestically produced vehicles remained above the base-year level, which effectively meant a 50 percent Canadian content requirement.

The agreement was asymmetrical: US imports required a 50 percent US-Canadian content for duty free treatment. The agreement helped US companies rationalize inefficient Canadian production that had been operating well below efficient scale because of punitive tariffs. For the Canadians, it was a way to improve efficiency and lower consumer prices, without reducing tariffs. The agreement was successful in expanding production, improving efficiency, and lowering prices in Canada.
The Canadian regime in the auto pact was ruled illegal under the World Trade Organization (WTO) rules in 2000, in a case brought by Japan and the European Union, because it violated national treatment, the most favored nation (MFN) principle, and consisted of an illegal subsidy.

**HOW MUCH US CONTENT IS IN VEHICLE IMPORTS FROM CANADA AND MEXICO?**

Vehicle imports from Canada and Mexico under NAFTA currently are estimated to contain about 25 percent US content. The National Highway Traffic Safety Administration (NHTSA) reports statistics for the US and Canadian (joint) content for all vehicles sold in the United States, as well as information on where final assembly occurs. NHTSA data show that on average US-Canadian content makes up 24 percent of vehicles exported from Mexico to the United States, which are eligible for NAFTA preferences. This is a simple average, since the data do not record the share of each model in exports. Although US and Canadian content are not distinguished, content is mostly from the United States, as exports of US auto parts to Mexico are 20 times greater than exports of Canadian parts. The content value varies widely between vehicle models; the Mazda Scion has only 5 percent US-Canadian content while the Chevrolet Trax has 55 percent. US brands tend to have somewhat higher US-Canadian content, averaging 32 percent. The same data show that vehicles imported from Canada that qualify for NAFTA preferences have on average 64 percent US-Canadian content.

The OECD TiVA database, which combines input-output tables with import and export data, can also be used to estimate US content. The TiVA data show that 18 percent of the value of US motor vehicle imports from Mexico originates in the United States; for Canada the corresponding figure is 24 percent. These data are lower bounds because they include exports of both vehicles and parts, and parts have less US content. In addition, these data include trade that does not take advantage of NAFTA.

**WOULD A 35 TO 50 PERCENT US CONTENT REQUIREMENT LEAD TO MORE US CONTENT IN IMPORTS?**

Although Canadian production expanded under the Auto Pact, that does not imply that content requirements will similarly expand US production. The Canadian auto industry was highly inefficient before the Auto Pact was implemented, so the pact was liberalizing relative to the status quo. In addition, the North American industry faced relatively little global competition in that period.

By contrast, North American production is now operating at an efficient scale, with complex global supply chains. Auto production is highly competitive around the world and US content requirements would be more restrictive relative to the status quo. As a result, the North American industry would likely become less competitive with content requirements and could contract.

Suppose the administration required vehicles to have 35 percent US content. The models with 35 percent or more US content, such as the Chevy Trax, would continue to enter the United States under NAFTA preferences. For models with 30 to 34 percent US content, producers might increase the use of US parts to qualify for NAFTA treatment. But for models with less than 30 percent US content, like the Mazda Scion, producers may find it too costly to shift supply chains. For cars, they would likely switch to exporting through the 2.5 percent tariff. Once they make this switch, the old rule of origin—62.5 percent regional content—will no longer be binding. Some of the parts that formerly came from the United States might then be replaced by Asian or European parts.
US content could fall more sharply if the foreign producers chose to export from their home region instead of from Mexico or Canada. For example, Japanese producers might decide to export more from Japan if the stricter rule made production in Mexico less profitable. Vehicles imported from Japan have only 3 percent US-Canadian content on average, so demand for US parts would fall.

Thus, while a US content requirement will increase the US content share in duty-free imports that come into the United States through NAFTA, the share of US content in total imports could fall if companies stopped trading through NAFTA.

A US content requirement would likely have a greater impact on light trucks, which face a 25 percent US tariff. However, the NHTSA data show that trucks produced in Mexico already tend to have high US-Canadian content, averaging 39 percent. (Light trucks are no longer produced in Canada for export the United States.)

**STREAMLINING RULES OF ORIGIN IS A BETTER WAY**

The administration has the worthy goal of wanting to boost US manufacturing. Unfortunately, doing it with content requirements or raising rules of origin in NAFTA could backfire. A better way would be to support the North American supply chain by streamlining rules of origin. If North America becomes the most competitive place in the world to produce cars and trucks, then US consumers will benefit from lower prices, and there will be more jobs—for the United States as well as Canada and Mexico.

**AGRICULTURE**

**Agriculture in the NAFTA Renegotiation**

*By Cullen S. Hendrix*

Agriculture will feature prominently in the upcoming NAFTA renegotiations, despite its modest contribution to total intra-NAFTA trade and resultant surpluses/deficits. Agriculture accounted for roughly 7 percent of US trade with Canada and with Mexico and 8 percent of US trade’s modest surplus with Canada and deficit with Mexico in 2016. These shares are small but significant. For select products, however, the shares are much higher: Mexico received 28 percent of the US maize crop and Canada and Mexico account for nearly a third of US beef exports. These market shares imply large potential for retaliation—as US losses—even if agriculture’s contribution to intra-NAFTA trade is relatively minor.

Three points are worth making in advance of the negotiations:

1. **US and Canadian agricultural producers like NAFTA and will fight hard to preserve it.** Aside from some wrangling over market access issues for dairy, poultry, and eggs and recent spats over Canadian softwood lumber, farm organizations in both countries view NAFTA positively. Public opinion in Mexico is more ambivalent, but NAFTA has created strong export-oriented agricultural interests in the country’s north that balance more protectionist interests in the south.

The [US Farm Bureau](https://www.usfb.org), the largest farm lobbying organization in the United States, is decidedly pro-NAFTA,
arguing that “Any renegotiation [of NAFTA] must protect the gains achieved in agricultural trade and work to remove remaining barriers to trade with Canada and Mexico.” The National Cattlemen’s Beef Association expressed a similar sentiment regarding prominent trade deals like the Trans-Pacific Partnership (TPP) and NAFTA: “Since NAFTA was implemented, exports of American-produced beef to Mexico have grown by more than 750 percent. We’re especially concerned that the Administration is taking these actions without any meaningful alternatives in place that would compensate for the tremendous loss that cattle producers will face without TPP or NAFTA.” US farmers do not, in the main, want to curtail or roll back market access—they want to expand it.

2. Despite not being as extensive as those in other industries, NAFTA has created complex cross-border agricultural supply chains that create value added for the US economy, particularly in GOP-leaning states. Pork is an excellent example. In 2014 the United States imported 4.9 million Canadian pigs, 3.9 million of which were feeders, 8- to 12-week old juvenile pigs weighing 10 to 60 pounds. These pigs are birthed and weaned on Canadian farms before being exported to states such as Iowa, Minnesota, Illinois, and Indiana where they can be finished—fed to eventual slaughter weight—on inexpensive US corn and soybean meal, and then slaughtered and processed in US facilities. The resulting pork products are then either consumed domestically in the United States or exported to the Canadian and Mexican markets.

Thus a pork cutlet consumed in Toronto may have started life as a piglet on an Ontario farm before being exported to the United States and then reimported as a US-produced finished cut. Interrupting this supply chain would have adverse effects for both Canadian and US producers and consumers. Similar situations obtain with respect to grains, oilseeds, and processed foods and livestock.

3. Disruptions to NAFTA could create big problems for Trump-voting states and states with GOP and split Senate delegations, especially those that rely heavily on agricultural exports and intra-NAFTA trade. This administration cannot hope for successful ratification of a renegotiated NAFTA without the support of the heavily agricultural, highly intra-NAFTA trade–dependent delegations from the Dakotas, Iowa, Kansas, Missouri, Montana, and Nebraska. Reopening NAFTA entails mostly downside risk for these delegations, as the status quo favors their products.

A successful NAFTA renegotiation would incorporate many of the provisions of the successfully negotiated Trans-Pacific Partnership, including the removal of export subsidies and resolution of several sanitary phytosanitary standards (SPS) related issues. The TPP addressed all four objectives identified in then-acting US Trade Representative Stephen Vaughn’s March 30, 2017, draft letter to Congress. The TPP would have required all members to abolish export subsidies, including Mexico’s for wheat and Canada’s for dairy products sold in the United States. The SPS chapter of the TPP would have obligated member countries to use science-based risk analysis for evaluating SPS threats, effectively harmonizing these procedures to those of the United States, and would have established a rapid reporting system for all SPS-related detained shipments, a cooperative technical consultation system for SPS issues, and a dispute resolution mechanism for SPS-related issues.

NAFTA has been a considerable boon to agricultural interests across the United States, Canada, and Mexico, spurring intra-NAFTA trade and resulting in greater consumer choice in each. The USTR must be careful not to let agriculture become a casualty of disputes over unrelated issues, as the trade agreement has been largely successful in integrating and expanding the North American agricultural market.
The Trump administration’s plan to renegotiate NAFTA could disproportionately harm states that voted for Trump in 2016 if agricultural exports are hampered. The maps above show the states with economies most reliant on agriculture exports to NAFTA countries, including Nebraska, South Dakota, Iowa, Montana, and Kansas. Maine, which voted for Clinton, also gains greatly. Farm exports to Mexico and Canada have grown at a faster rate than exports to the rest of the world since NAFTA was enacted.
Leaving NAFTA would hurt US corn farmers.

Mexican tariffs on yellow corn from:

- Brazil and Argentina: 0%
- US with NAFTA: 0%
- US without NAFTA: Up to 37%

Sources: ALADI, Mexico – Mercosur agreement 54 and 55 (Acuerdo de Complementación Económico, ACE 54/55), compiled by Monica de Bolle, and Mary Amiti and Caroline Freund’s blog post, “US Exporters Could Face High Tariffs without NAFTA.” Shipping costs from South America to Mexico are low.

BUSINESS INVESTMENT AND EXPORTS

Cross-border investment is significant

- US in Mexico: $93 billion
- US in Canada: $353 billion
- NAFTA in US: $286 billion

US investment in Mexico is only 2% of total US direct investment abroad.
The End of NAFTA? What Policymakers Should Know

NAFTA Doesn’t Need a Senseless Sunset

By Jeffrey J. Schott

The Trump administration wants a revised North American Free Trade Agreement (NAFTA) to include a sunset provision terminating the pact after five years unless all three countries approve its renewal. Such a clause would insert a fixed expiration date for NAFTA and require positive and politically fraught decisions to maintain tariff-free access to the three markets.

Sunset clauses have never been included in US trade agreements for the simple reason that they undercut the basic economic benefits of the deal. The added uncertainty over the future policy outlook in North America, and the threat of revived US import restrictions and higher tariffs against US exports, would discourage investment and dampen growth prospects in all three countries. The Trump administration’s sunset proposal is senseless … and unnecessary.

Flaws in trade pacts, whether due to negotiating error or changes in market conditions, can be remedied by NAFTA’s amendment procedures or termination clauses. Because the former can be difficult and time-consuming, and the latter drastic and disruptive to output and employment in each partner country, NAFTA also contains provisions that delegate powers to the trade ministers—meeting together as the NAFTA Free Trade Commission—to interpret or modify specific rules or obligations of the pact. Over the past 23 years, NAFTA trade ministers have done so both to narrow the application of investor-state dispute settlement provisions and to modify industry-specific rules of origin to support North American production and trade.

Sunset clauses have value when used in the proper context. Multilateral trading agreements under the World Trade Organization (WTO) already include sunset clauses in specific areas:

First, WTO rules require that antidumping (AD) and countervailing duties (CVD) be lifted once the trade-distorting effects of the foreign unfair trade practices have ended and that ongoing AD and CVD orders be reviewed at least every five years to determine whether they should be extended, modified, or removed.

Second, WTO rules also require that safeguard measures—temporary protection that helps domestic industry adjust to injurious import competition regardless of whether the products benefit from unfair trade practices or not—must be time-limited and the protection reduced incrementally. The latter criterion is waived in the case of agricultural products subject to seasonal safeguard measures.

Third, the WTO Agreement on Subsidies and Countervailing Measures, negotiated in the Uruguay Round of multilateral trade negotiations, also provided a 5-year exemption from the prohibition on export subsidies for specified purposes, such as research and development (so-called “green light” subsidies). Article 31 of that accord limited the application of Article 8 on nonactionable subsidies to five years but allowed for consideration of its extension. The exemption for such green light subsidies expired in 1999.

The sunset clause in the Subsidies Agreement is the only precedent that even barely resembles what the Trump administration wants to do for the NAFTA writ large. But, as my colleague Chad Bown reminded me, all three precedents aimed at limiting import restrictive measures, while a NAFTA sunset clause would do just the opposite.
Trade agreements are designed to establish rules to govern trade and investment among the partner countries, making market entry and regulatory requirements for conducting business clear and predictable. Policy predictability enables businesses to better plan their production, trade, and investment strategies to enhance their competitiveness and bolster economic growth.

Adding a sunset clause that terminates the agreement after five years unless a positive agreement is reached to extend it, as the Trump administration proposes, would do the opposite. The threat of termination of NAFTA after five years would generate uncertainty that would constrain investment decisions in all three NAFTA countries and undercut efforts to deepen North American supply chains. We already see evidence of such desultory results as Mexican firms, in the face of President Trump’s ill-considered threats to withdraw from NAFTA, reach out to Asian and Latin American suppliers to diversify away from US firms.

To paraphrase an old admonition, loose lips sink ships—in this case, those carrying US exports throughout the Pacific Basin, including Mexico. US trade officials should carefully reconsider and refrain from sunset proposals that contain bluster but no benefit for the US economy.

**Social Media Graphic** Sunset Clause Makes Business Conditions Unpredictable

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**US Exporters Could Face High Tariffs without NAFTA**

*Mary Amiti (Federal Reserve Bank of New York) and Caroline Freund (PIIE)*

An underappreciated benefit of the North American Free Trade Agreement (NAFTA) is the protection it offers
US exporters from extreme tariff uncertainty in Mexico. US exporters not only have gained greater tariff preferences under NAFTA than Mexican exporters gained in the United States but also have been exempt from potential tariff hikes facing other exporters. Mexico’s bound tariff rates—the maximum tariff rate a World Trade Organization (WTO) member can impose—are very high and far exceed US bound rates. Without NAFTA, there is a risk that tariffs on US exports to Mexico could reach their bound rates, which average 35 percent. In contrast, US bound rates average only 4 percent. At the very least, US exporters would be subject to a higher level of policy uncertainty without the trade agreement.

**US-MEXICAN TRADE UNDER NAFTA**

Since joining NAFTA in 1994, the US share of trade with Mexico has grown, as shown in the chart below. Mexico’s share has risen to 14 percent of total exports and imports. In the same time frame, the US share of trade with China has increased even more rapidly, although no free trade agreement with China is in place. Mexico’s export and import shares are the same, but China accounts for a much bigger share of US imports than of US exports.

**US BENEFITS FROM PREFERENCES IN MEXICO**

Often forgotten in the debate about NAFTA are the benefits to US companies. NAFTA grants US exporters duty-free access to the Mexican market in exchange for duty-free access for Mexican exporters in the US market. By contrast, exports from WTO member countries that do not have free trade agreements with either Mexico or the United States are subject to “most favored nation” (MFN) applied tariffs in those countries.

Currently, applied MFN tariffs are higher in Mexico than in the United States—an indication that the United
States receives more extensive preferences in Mexico than Mexico receives in the United States. In the absence of NAFTA, the average tariff on Mexican exports to the United States would be 3.7 percent, whereas the average tariff on US exports to Mexico would be 7.4 percent. About a quarter of US exports would be subject to tariffs above 5 percent. By contrast, only 15 percent of Mexican exports would be subject to tariffs above 5 percent. However, with NAFTA, all trade between Mexico and the United States is duty-free, so these asymmetric preferences offer the United States a relatively good deal.

Without NAFTA, Mexico would have more freedom to raise tariffs on its imports under international rules than would the United States. The reason is that Mexico's bound rates—the maximum rate a WTO member can impose—are well above its applied MFN rates. In contrast, US tariffs are bound at applied rates. In successive multilateral trade liberalization rounds, the United States and other advanced countries agreed to bind their tariffs at progressively lower levels to protect member countries against trade wars and to sustain trade liberalization. If a member country were to raise tariffs on imports from WTO members above bound rates, WTO rules would require it to compensate affected members.

Developing countries were largely excluded from these tariff commitments. Unlike the United States, where tariffs are bound at the lower applied MFN rates, Mexican tariffs are bound at rates above their applied MFN tariffs. The average bound rate for Mexico is 35 percent. More than 90 percent of US exports to Mexico are in products with bound tariff rates above 30 percent (see chart below). The large gap between the bound rates and the applied rates, known as the “binding overhang,” means that Mexico can raise tariffs significantly without breaking international rules, provided it does so on a nondiscriminatory basis.

**US-Mexican export shares by bound tariff rates**

![Chart showing US-Mexican export shares by bound tariff rates.](source: World Bank, World Integrated Trade Solution.)
This binding overhang implies that countries not in trade agreements with Mexico face significant policy uncertainty. Recent research finds evidence of depressed investment and trade in countries facing the uncertainty of higher tariff rates on their exports.

It would not be unusual for Mexico to raise MFN tariffs, taking advantage of high bindings governing its trade. Mexico’s average tariff rose from 13 percent in 1995 to more than 18 percent in the early 2000s when tariffs increased by 50 percent or more on some agricultural products. Car parts and textiles and apparel also faced steep tariff hikes. Eventually, the increase in external protection created large preferences for NAFTA goods, which was costly for the Mexican economy. Importers were shifting to US goods, even when the United States was not the lowest-cost producer and imports from the United States did not bring in tariff revenue. Research shows that this so-called trade diversion encouraged unilateral trade liberalization to ensure that imports external to trade agreements were not cut off.

Given the large and well-documented benefits from low trade barriers, particularly those stemming from access to a wider variety of imported intermediate inputs and lower prices of intermediate inputs, it would not be in Mexico’s interest to raise all of its MFN tariffs to their bound rates. But Mexico has the flexibility to do so and may choose to do so on some products in the absence of NAFTA. MFN tariff hikes, which are nondiscriminatory, could disproportionately affect the United States because Mexico has other free trade agreements. The vast majority of Mexico’s imports enter duty free as a result of its 19 trade agreements. If MFN tariffs were increased on products available from other free trade partners and the United States, only other trade agreement partners would be protected if US exporters were not insured with NAFTA. For example, Mexico’s bound rate on steel is 35 percent. Mexico accounts for 30 percent of US steel exports, but it could turn to many alternative suppliers, damaging US exports, with little (if any) additional cost to Mexican steel importers.

In another example of the potential harm to US interests, it is worth recalling that NAFTA’s liberalization of US corn exports was strongly opposed by Mexican growers 25 years ago. The bound rate on corn—one of the largest US exports to Mexico and a crop considered to be a national heritage in Mexico—is 37 percent. Thus Mexico could raise its tariff on US-grown corn to 37 percent without breaching any international rules.

Put simply, Mexico has a lot of room to raise tariffs, up to its bound rates of about 35 percent. In contrast, the United States has less room to adjust its tariff rates without breaching WTO rules because the US MFN tariff rates of about 4 percent are already at their bound rates. Thus, for US exporters, NAFTA offers a valuable insurance policy against Mexican tariff hikes.

**TRADE DEFICIT**

**Scrapping NAFTA Will Sink the Peso and Expand Trade Deficit**

*By Caroline Freund*

The threat of a trade war with Mexico has receded as talks proceed this fall over renewing the North American Free Trade Agreement (NAFTA). One telling result is that the Mexican peso, which had plummeted in value against the dollar after Trump’s election and again after he took office, has recovered. The peso’s exchange rate
The value is now stabilized at a level that is actually higher than it was before last November.

The sharp peso depreciation last winter provides yet another example of the dangers for President Trump of pursuing policies that backfire. The more the United States actually pursues a policy of slapping tariffs on Mexico’s imports to the United States—which happen to represent 80 percent of all of Mexico’s exports—the more the peso declines. And the more that happens, the cheaper Mexican exports to the United States will be.

Accordingly, the administration should be wary of blowing up the talks with actions rather than words. Peso movements would very likely compensate any loss in Mexican competitiveness due to tariffs.

Right now, however, markets are yawning in response to tough talk on NAFTA. When President Trump recently announced that he would probably pull out of NAFTA, there were only brief and minor jitters in exchange markets.

The formal renegotiation process seems to have had a calming effect. Since the US Trade Representative issued a letter to Congress in May, indicating its intent to renegotiate NAFTA, the peso has gained and stabilized.

In contrast, when Donald Trump won the election, the peso plummeted more than 10 percent (similar to the pound’s decline vis-à-vis the euro immediately after the Brexit vote). In January, amid heightened uncertainty about the future of NAFTA, the peso sank another 5 percent. Rumors that Trump was planning to sign an executive order to begin the process of withdrawing from NAFTA led the peso to dip nearly 5 percent in April.
After a full peso recovery, exchange rate speculators won't be fooled so easily again. It will take more than a tweet.

But renegotiation talks could still get derailed. And what we have learned from these past experiences is that if NAFTA is scrapped the peso will plunge.

The irony is that the very reason the Trump trade team hates NAFTA—the bilateral deficit—would likely get larger as a result. The deficit would worsen because trade responds to both tariffs and exchange rates. Without NAFTA, goods crossing the border would face tariffs and a weaker peso.

For example, a 15 percent peso depreciation seems reasonable judging from the winter experience and Brexit. Coupled with an average US tariff of less than 4 percent, it would make goods imported from Mexico 11 percent cheaper in the United States. In contrast, US goods, facing an average tariff of 7 percent, would become on average 22 percent more expensive in Mexico.

There will also be important distributional consequences. Some producers and consumers in both countries will lose. For example, US agriculture exporters, facing a stronger dollar and high Mexican tariffs, will lose; US consumers of light trucks, which would face high US tariffs in the absence of NAFTA, will also lose.

In sum, because exchange rates adjust, Mexican exporters will be compensated for the loss in competitiveness without NAFTA. In the short run, if history is a good guide to how much the peso will depreciate, the US-Mexico trade deficit would very likely expand in the absence of NAFTA.

**Video Three Reasons Why Trump’s NAFTA Strategy to Reduce Trade Deficits is Misguided**

For NAFTA, the Trump administration wants the United States to “ensure truly fair trade” by reducing its trade deficit with Canada and Mexico. There are three reasons why this strategy is misguided.