



NAFTA/USMCA: *Past, Present And Future*

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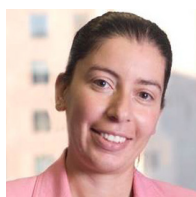
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TABLE OF CONTENTS

Executive Summary 2

Introduction 4

NAFTA: A Brief History 5

The Economies of the Partners before the Agreement..... 6

NAFTA: Goals and Highlights of the Agreement..... 8

Impact of NAFTA over the Years 10

NAFTA and Key Industries: A Brief Look at Automotive Industry and
Energy Sector 13

NAFTA Renegotiations: Sticking Issues 15

What is in Proposed USMCA? 16

Where Could We End Up? 16

Conclusion..... 19



EXECUTIVE SUMMARY

In recent years, rising nationalism globally has begun to spell trouble for the world trading system. This has been especially true for the world's largest economy. The U.S. President Trump followed through on his campaign promise regarding the North American Free Trade Agreement (NAFTA) by notifying Congress about his intent to renegotiate the 24 year old free trade pact, which began a long up and down process culminating in the U.S.-Mexico-Canada Agreement (USMCA) on September 30 2018. However, given statements by both Republican and Democratic lawmakers concerning certain provisions in the deal, there is some uncertainty about U.S. ratification.

Regardless of the political discussions surrounding the issue, many economic experts believe that NAFTA has had an overall positive impact on the U.S. economy, as well as the North American economy and that terminating NAFTA could decrease economic activity in the region. Lawmakers should take a note of long and successful history of trade relations between three countries and approve USMCA without delay.

- **USMCA will have a positive impact compared to a NAFTA baseline:** A recent IMF study, considering only certain provisions in USMCA, shows that welfare will improve in North America through modernizing and integrating the trade facilitation to further reduce trade costs and border inefficiencies. In addition, another scenario analyzed by the IMF shows that in addition to USMCA, ending U.S. tariffs on steel and aluminum and the reciprocal elimination of Canadian and Mexican retaliatory import surtaxes would create larger economic gains for

all three countries. The International Trade Commission's deeper analysis of USMCA also finds positive impacts: An upgrade from current NAFTA baseline to USMCA is expected to raise U.S. real GDP by over \$68 billion and employment by 176,000 jobs.

- **Three Countries were working closely before NAFTA:** The history of NAFTA predates the beginning of actual negotiations between the U.S. and Mexico in 1990, with Canada joining the discussion in 1991. The 1965 U.S.-Canada Automotive Products Agreement, was the first important step in creating an integrated North American auto sector by removing the tariffs on cars, trucks, buses, tires, and automotive parts between the two countries. The success of the auto agreement over the following two decades was one of the important factors that encouraged the Canadian and the U.S. governments to consider a broader trade agreement, the Canada-U.S. Free Trade Agreement (CUSFTA) which was signed on October 3, 1987. While Canada and U.S. were actively integrating their economies, U.S. was also instrumental in Mexico's accession to GATT. The U.S. was interested in a free trade agreement with Mexico in order to have extended access to a large emerging market with 100 million people, as well as to support the flourishing democracy along its southern border.
- **NAFTA was signed to improve the relationship further:** Goals of NAFTA included creating efficiency gains in production and consumption through lowering costs, taking advantage of economies of scale by combining all three markets, increasing the competition and most importantly reducing the uncertainty for all three countries involved.

- **The majority of the original goals of NAFTA were achieved:** Through elimination of tariffs and the majority of non-tariff barriers, trade between all three countries boomed. Overall trade in goods and services between U.S. and its NAFTA trading partners almost quadrupled, from \$337 billion in 1993 to \$1.3 trillion in 2017. Both Canada and Mexico are continuously among the top three countries for overall U.S. exports and imports. The close ties between three countries are also apparent in foreign direct investment (FDI) data. Both before and after enactment of NAFTA, the U.S. was the largest source of FDI in Mexico. NAFTA was also instrumental in opening large markets for U.S. small businesses. According to research by the Small Business and Entrepreneurship Council, 75.4 percent of the firms exporting to Canada and 72.7 percent of the firms exporting to Mexico had fewer than 50 employees.
- **NAFTA has been good for the U.S. economy:** A number of studies have quantified the impact of NAFTA on the U.S. economy. Caliendo and Parro (2015) found that the reduction of tariffs on goods boosted U.S. welfare by 0.1 percent of GDP. Similarly, a 2016 ITC report showed that all U.S. free trade agreements combined boosted U.S. GDP by 0.2 percent, with the majority of that increase coming from NAFTA. Matthew Slaughter, who surveyed the existing studies, concluded that NAFTA increased U.S. GDP by a range of 0.2 to 0.3 percent.
- **Automotive Industry and Energy Sector highlight the success of integration through NAFTA:** According to the recent data, while motor vehicles are the top import for the U.S., motor vehicle parts are the top export. Since NAFTA was enacted, labor productivity in the auto sector increased significantly. Based on a Boston Consulting Group study, the U.S. has seen the highest boost in output per employee, from 9.3 to 12.7 vehicles per employee, between 1995 and 2016. NAFTA has been crucial for North America to remain competitive in world markets by relocating parts of its auto manufacturing based on the cost advantages of three countries. The energy sector is also a vital component of trade between three countries. In addition to the shale revolution, NAFTA has driven integration of energy markets in North America. While Canada is the largest supplier of crude oil to the U.S., both Mexico and Canada are major buyers of petroleum products refined in the U.S. The energy linkage between all three countries was further improved after the 2013 energy reforms in Mexico that allowed for private investment in this sector. These reforms, in combination with the investor protections in NAFTA, were instrumental for foreign direct investment by American companies in electricity transmission, purchases of oil and gas leases, as well as renewable production in Mexico. All these changes and market forces over the years, as well as projections of future consumption and production, points to the possibility of North American energy self-sufficiency.
- **What happens if we terminate NAFTA:** There are a number of studies that show the negative impact of NAFTA termination. A recent study by Joseph Francois and Laura M. Baughman, for example, shows that under various scenarios jobs losses could be between 1.8 to 3.6 million U.S. workers and GDP losses could be between 0.6 to 1.2 percent. Another study by ImpactEcon found a reduction of 1.2 million jobs and a 0.6 percent loss in output. The Francois and Baughman study also shows that terminating NAFTA could increase jobs in China, Japan, Korea and Germany.

INTRODUCTION

In recent years, rising nationalism globally has begun to spell trouble for the world trading system. This has been especially true for the world's largest economy, the U.S., during and after the 2016 Presidential Election. The rhetoric about free trade that began with the campaign, coming from both candidates, has continued since President Trump took office. Furthermore, that rhetoric has been the basis for a number of policy actions. For example, one of the first executive orders issued by President Trump after his inauguration in January 2017 was to pull the U.S. out of the Trans Pacific Partnership (TPP) negotiations.¹ Later, he followed through on his campaign promise regarding the North American Free Trade Agreement (NAFTA) by notifying Congress about his intent to renegotiate the 24 year old free trade pact, which began a long process culminating in the U.S.-Mexico-Canada Agreement (USMCA).² During almost 16 months of back and forth between three parties, statements by President Trump raised questions about the future of the NAFTA. On many occasions President Trump had stated that if he cannot reach a fair deal, he would terminate the agreement, causing great concern for policymakers on both sides of the aisle as well as businesses which had been working under the rules of NAFTA for the last quarter century.³ Despite the ups and downs, the negotiators reached a deal on September 30 2018. However, given statements from both Republican and Democratic lawmakers concerning certain provisions in the deal, there is some uncertainty about U.S. ratification.⁴

Despite the political discussions surrounding the issue, many economic experts believe that NAFTA has had an overall positive impact on the U.S. economy,⁵ as well as the North American economy and that terminating NAFTA could decrease economic activity in the region.

Given the diversion of economic thinking and politics surrounding NAFTA and the USMCA, this paper aims to look at the economic facts, studies, and data in order to evaluate the trade deal's importance for both the U.S. and its partners, Canada and Mexico. This special report starts with a short history of the agreement to provide context, including a look at the economies of the three countries at the time NAFTA was put into place, and continues with NAFTA's impact over the years. Using existing micro and macro studies, the report describes the possible economic outcomes of terminating NAFTA both at the aggregate level and at the industry level as well as the USMCA's potential impact on the region's economy.

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- 1 "Presidential Memorandum Regarding Withdrawal of the U.S. from the Trans Pacific Partnership Negotiation and Agreement," The White House, January 23, 2017. <https://www.whitehouse.gov/presidential-actions/presidential-memorandum-regarding-withdrawal-united-states-trans-pacific-partnership-negotiations-agreement/>
 - 2 "USTR: Trump Administration Announces Intent to Renegotiate the North American Free Trade Agreement," Office of the United States Trade Representative, May 2017. <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2017/may/ustr-trump-administration-announces>
 - 3 "Trump Agrees Not to Terminate NAFTA 'At This Time,' Says He'll Renegotiate," NBC News, April 2017. <https://www.nbcnews.com/card/trump-won-t-terminate-nafta-instead-renegotiate-trade-deal-n751846>
 - 4 "Congressional resistance to Trump's trade deal is bipartisan, but also fractured," Washington Examiner, December 14, 2018. <https://www.washingtonexaminer.com/policy/economy/congressional-resistance-to-trumps-trade-deal-is-bipartisan-but-also-fractured>
 - 5 When asked "On average, citizens of the U.S. have been better off with the North American Free Trade Agreement than they would have been if the trade rules for the U.S., Canada and Mexico prior to NAFTA had remained in place." 85 percent of surveyed economists agreed or strongly agreed. Chicago Booth, IGM Forum, March 13, 2012. <http://www.igmchicago.org/surveys/free-trade>

NAFTA: A BRIEF HISTORY

The history of NAFTA predates the beginning of actual negotiations between the U.S. and Mexico in 1990, with Canada joining the discussion in 1991. The idea was introduced during Ronald Reagan's first presidential campaign in 1979, mainly encouraged by economic integration in Europe following the Treaty of Rome in 1957. Over the years the European Economic Community, which began with six countries, had expanded and established a customs union. This integration helped support economic growth in the region.⁶

During a campaign speech in 1979, the future President appealed to the crowd with arguments that are still relevant today:

"We live on a continent whose three countries possess the assets to make it the strongest, most prosperous and self-sufficient area on Earth. Within the borders of this North American continent are the food, resources, technology, and undeveloped territory which, properly managed, could dramatically improve the quality of life of all its inhabitants.

It is no accident that this unmatched potential for progress and prosperity exists in three countries with such long-standing heritages of free government. A developing closeness among Canada, Mexico, and the United States—a North American accord—would permit achievement of that potential in each country beyond that which I believe any of them—strong as they are—could accomplish in the absence of such cooperation. In fact, the key to our own future security may lie in both Mexico and Canada becoming much stronger countries than they are today."⁷

The larger two economies within NAFTA, the U.S and Canada, had first attempted greater economic cooperation with a bilateral trade agreement in 1911 that was signed by President William Howard Taft and Canadian Prime Minister Sir Wilfred Laurier, but was quickly rejected by the Canadians after their subsequent election.⁸ Canada's protectionist "National Policy," which through increased tariffs, remained

in effect until the establishment of the General Agreement on Tariffs and Trade (GATT) in 1947. GATT was instrumental to slowly dismantling the National Policy and lowering tariff rates in Canada.

In the early 1960s, due to production inefficiencies and fierce competition coming from the U.S., Canada developed the Drury Plan to support their struggling auto sector. The plan provided financial incentives to auto parts exporters to increase investment and production in Canada.⁹ U.S. firms responded to the Drury Plan by filing a petition with the U.S. Customs Commission requesting countervailing duties against Canadian subsidies. President Johnson responded by asking the State Department to negotiate the issue with Canada. The President believed that "imposition of countervailing duties might lead to a Canadian-American trade war."¹⁰

The 1965 U.S.-Canada Automotive Products Agreement, was the first important step in creating an integrated North American auto sector by removing the tariffs on cars, trucks, buses, tires, and automotive parts between the two countries.¹¹ The agreement had a positive impact on the automotive industry on both sides of the border. Within the first four years of the agreement, Canada increased its exports tenfold and imports fourfold. In addition, by the end of the decade Canadian wages were at parity with U.S. wages.¹²

The success of the auto agreement over the following two decades was one of the important factors that encouraged the Canadian government to consider a broader trade agreement with the U.S. Matched with President Reagan's goal of North American integration, the Canada-U.S. Free Trade Agreement (CUSFTA) was signed on October 3, 1987. At the time, this comprehensive bilateral trade agreement included some historic provisions:¹³

- Many tariffs on goods were eliminated immediately with the remaining ones to be phased out by 1998.
- Financial services trade was liberalized, and services industries covered by agreement received national treatment.
- Foreign Direct Investment (FDI) was encouraged by providing national treatment for all companies engaging in cross border FDI between the two countries

6 "The History of European Union," https://europa.eu/european-union/about-eu/history_en

7 Ronald Reagan, "Remarks Announcing Candidacy for the Republican Presidential Nomination," November 13, 1979, <http://www.presidency.ucsb.edu/ws/?pid=76116>

8 M. Angeles Villarreal and Ian F. Fergusson, "The North American Free Trade Agreement (NAFTA)," Congressional Research Service, May 24, 2017, 7-5700, <https://fas.org/sgp/crs/row/R42965.pdf>

9 "The U.S.-Canadian Automotive Products Agreement of 1965: An Evaluation for its Twentieth Year," Lyndon B. Johnson School of Public Affairs, The University of Texas at Austin, 1985, <https://repositories.lib.utexas.edu/handle/2152/20743>

10 Ibid, pg 2.

11 Villarreal and Fergusson, 2017

12 Karyne Charbonneau, Daniel de Munnik and Laura Murphy, "Canada's Experience with Trade Policy," Bank of Canada, January 2018, <https://www.bankofcanada.ca/wp-content/uploads/2018/01/sdp2018-1.pdf>

13 Villarreal and Fergusson, 2017

- The imposition of performance requirements on the operations of each country's companies in the other country, such as local content, import substitution, or local sourcing requirements, were banned.
- Export restrictions on energy products, including minimum export prices, were prohibited.

While the U.S. and Canada were strengthening their trade relations, their southern neighbor was experiencing major economic and political developments. Mexico had followed a policy of import-substituting industrialization in the 1950s and 1960s, which aimed to encourage domestic industries by limiting competing imports. By the late 1970s, Mexico had begun experiencing economic difficulties, namely a debt crisis.¹⁴ Major reforms were undertaken in order to grow the economy, including liberalizing trade in mid-1980s. Mexico's accession to GATT, which the U.S. had actively lobbied for,¹⁵ was an important step in lowering its tariff rates, from a high of 100 percent to 20 percent by 1987.¹⁶

In the summer of 1990, the Salinas Administration in Mexico began to show interest in a free trade agreement with the U.S. This would not only liberalize the trade between the two countries, but would also signal the seriousness of Mexico's reforms to the world and help block the lobbying efforts of certain economic sectors of the economy to undo these reforms.¹⁷ The U.S. was interested in an agreement in order to have extended access to a large emerging market with 100 million people, as well as to support the flourishing democracy along its southern border.¹⁸

Talks between Mexico and the U.S. began in the summer of 1990. Canada later joined the talks in 1991. NAFTA was signed by President George Bush, Mexican President Salinas de Gortari, and Canadian Prime Minister Brian Mulroney on December 17, 1992 and went into force in January 1, 1994, creating the world's largest free trade area. The agreement was the first of its kind, bringing together two developed countries and one emerging economy.

THE ECONOMIES OF THE PARTNERS BEFORE THE AGREEMENT

After the signing of the agreement, the U.S. International Trade Commission (USITC) released a report¹⁹ outlining the potential impact of NAFTA on the U.S. economy. Given concerns about the Mexican economy's impact on U.S. jobs, famously raised by Ross Perot during the 1992 Presidential election,²⁰ Mexico's economic trends became an interest to many and were highlighted in the report. According to the report, after economic stagnation over the 1982-88 period, the Mexican economy grew by an average annual rate of nearly 4 percent from 1989 to 1991. Despite the report's prediction of a slow-down in Mexican growth to 2.7 percent, actual growth was 3.5 percent in 1992.²¹ FDI in Mexico was already on an upward trajectory prior to NAFTA. FDI was 81 percent higher in 1991 compared to 1990 and during the first half of the 1992 FDI increased by 13 percent. The U.S. had a large presence in Mexican trade as well as in its FDI, accounting for 70 percent of Mexican trade in 1991 and 61 percent of Mexico's cumulative FDI by value as of June 1992.

In fact, according to a study by Zylkin,²² the general trend in the early 1990s shows that the reforms in Mexico were already driving increased bilateral economic relations between the U.S. and Mexico and that NAFTA served to solidify and supplement this trend. The USITC study reports that Mexican exports grew by 19 percent during 1989-91 and imports rose by 50 percent. The growth of imports was attributable to purchases of capital goods to update Mexico's manufacturing base and infrastructure. The U.S. supplied two-thirds of these imports.

14 For further details, see the Case Study at Paul R. Krugman, Maurice Obstfeld and Marc J. Melitz, "International Trade: Theory and Policy," 11th Edition, 2018, pg 288.

15 Christina L. Davis and Meredith Wilf, "Joining the Club: Accession to the GATT/WTO," Princeton University, August 18, 2013, https://www.princeton.edu/~cldavis/files/joiningtheclub_DavisWilf.pdf

16 "Potential Impact on the U.S. Economy and Selected Industries of the North American Free Trade Agreement," USITC, January 1993, <https://www.usitc.gov/publications/332/pub2596.pdf>

17 Villarreal and Fergusson, 2017.

18 Gary Clyde Hufbauer and Jeffrey J. Schott, "NAFTA Revisited: Achievements and Challenges," Institute for International Economics, October 2005.

19 "Potential Impact on the U.S. Economy and Selected Industries of the North American Free Trade Agreement," USITC, January 1993, <https://www.usitc.gov/publications/332/pub2596.pdf>

20 During the debate, Perot stated that if NAFTA was not a two way agreement, it would create a "giant sucking sound" of jobs going south to the cheap labor markets of Mexico. <https://www.youtube.com/watch?v=xQ7kn2-GEmM>

21 World Bank National Accounts Data and OECD National Accounts Data Files, accessed March 2018, <https://data.worldbank.org/indicator/NY.GDP.MKTE.KD.ZG>

22 Zylkin, Thomas, "Beyond Tariffs: Quantifying Heterogeneity in the Effects of Free Trade Agreements," 2016, GPN Working Paper, Global Production Networks Centre, College of Arts & Social Sciences, National University of Singapore, http://www.tomzylkin.com/uploads/4/1/0/4/41048809/beyondtariffs_web_.pdf

At the time of the USITC report, Mexico's major challenges were financing its growing trade deficit, a shortage of skilled labor, and subpar infrastructure. Even though certain environmental issues were addressed through regulatory reforms, there were still concerns about the enforcement of these laws.

Canada, on the other hand, had already been collecting the fruits of CUSFTA. According to a 1992 report:²³

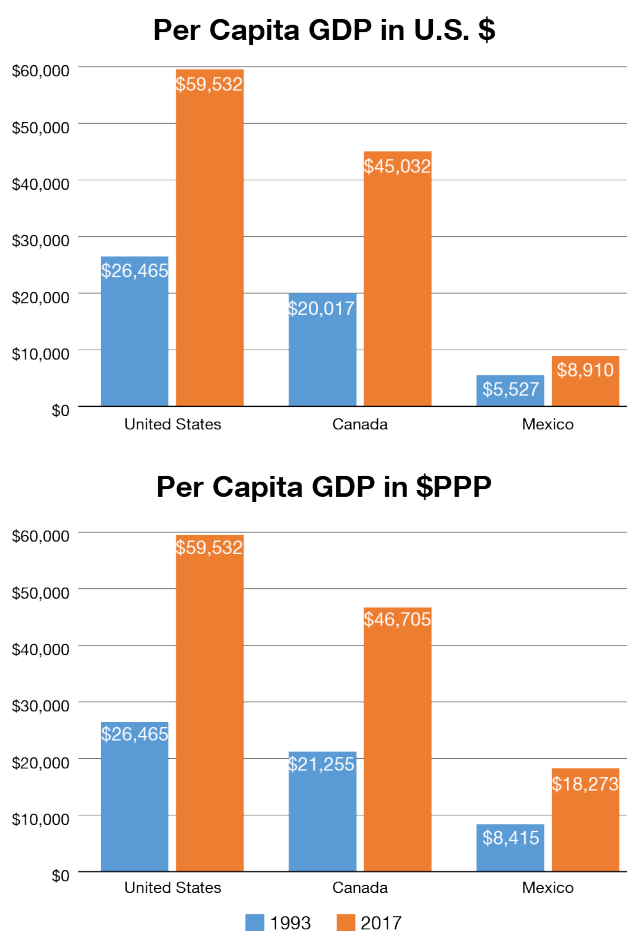
- Canada's exports to the U.S. over the CUSFTA's first three full years of operation were the strongest in those sectors that were liberalized by the agreement — particularly non-resource-based manufacturing.
- Imports into Canada also rose faster in those sectors that were liberalized under free trade.
- Canada's trade balance with the United States was more favorable than with the other regions over that period.

The Canadian report concluded that free trade with the U.S. was crucial to the development of high value added industries. Canada's interest in joining NAFTA was outlined in the report for the following reasons:

- **Extend the FTA to include the fast-growing Mexican market:** The phasing out of tariffs against Canadian products as well as access to certain Mexican government procurement contracts were important for Canadian economic interests.
- **Safeguard, improve, and clarify certain provisions of CUSFTA:** The agreement was expected to reduce the risk of unilateral interpretation by customs officials and diminish the use of the dispute-settlement provision. The inclusion of intellectual property issues was also important.
- **Preserve Canadian commercial interests in the U.S. market and Canada's attractiveness as a place to invest:** Canada was already facing competition from Mexico. According to some experts, if Canada was not part of NAFTA, "The United States would have been at the hub of separate free trade arrangements with the two spokes, Canada and Mexico. As the hub, the U.S. would have become the preferred location for investment, because it would enjoy better access to all three markets than either of the spoke countries."²⁴

To put all three countries in perspective before the NAFTA, we can look at GDP and the make-up of GDP in 1993. The Mexican economy, despite the country's large population, was quite small compared to the Canadian and U.S. economies. In 1993, GDP at current rates was \$577 billion in Canada, \$6,879 billion in the U.S., and \$501 billion in Mexico.²⁵ **Figure 1** shows per capita GDP in all three countries in 1993 and 2017 both at current dollars and at purchasing power parity (PPP current \$). In 1993, Mexican per capita GDP was just one fifth of per capita GDP in the U.S.

Figure 1. Per Capita GDP at Current Dollars and Purchasing Power Parity (Current \$) (1993 and 2017)



Sources: World Bank National Accounts Data and OECD National Accounts Data Files, accessed March 2019.

<https://data.worldbank.org/>

23 "North American Free Trade Agreement: An Economic Assessment from a Canadian Perspective," November 1992, http://publications.gc.ca/collections/collection_2016/fin/F2-227-1992-eng.pdf

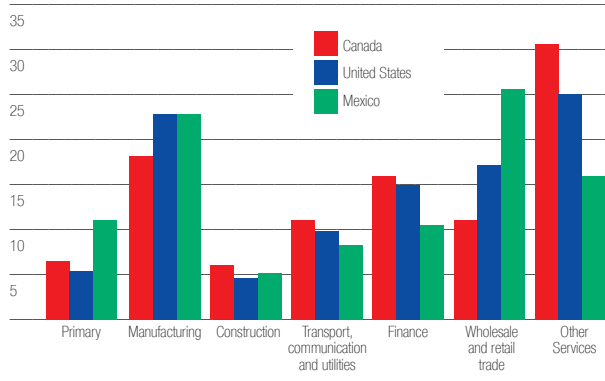
24 Ibid, pg 12

25 World Bank National Accounts Data and OECD National Accounts Data Files, accessed March 2018, <https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?end=2017&locations=CA-MX-US&start=1993>

It is also important to highlight the structural differences between the three economies. **Figure 2** shows that in 1990, the primary sector, which is comprised of agriculture, forestry, fishing and mining, played a significant role in Mexico, accounting for 11.1 percent of the Mexican economy, while it was approximately 7 and 6 percent in the Canadian and U.S. economies, respectively.²⁶

Figure 2. Broad structure of GDP, Canada, United States¹ and Mexico: 1990

Proportion of GDP (per cent)



¹ 1989 for the United States

Sources: Statistics Canada, Gross Domestic Product by Industry, cat. 15-001; U.S. Department of Commerce, Survey of Current Business (April 1991); International Monetary Fund, Recent Economic Developments in Mexico, (1991). http://publications.gc.ca/collections/collection_2016/fn/F2-227-1992-eng.pdf

NAFTA: GOALS AND HIGHLIGHTS OF THE AGREEMENT

Like any free trade agreement, the following general goals were underlying factors in the NAFTA agreement:

- Create efficiency gains in production and consumption in all three countries by improving the distribution of resources and lowering costs both for producers and ultimately for consumers.
- Take advantage of economies of scale by combining the markets of the three countries. Increasing the market size for producers and encouraging them to combine, specialize, and increase their production reduces the unit costs of production. This had been a key improvement for the automotive sector in the U.S. and Canada, first through the auto pact and then through CUSFTA.
- Competitive Effects. Increased competition in North America would encourage firms to innovate faster, increase productivity, and improve their bottom lines to be able to adapt to and survive market changes.
- Reduce Uncertainty. The agreement would decrease uncertainty by setting the rules for every player and thereby encourage investment and risk taking.

With the signing of NAFTA, the following key provisions were introduced to liberalize trade between the three partners:²⁷

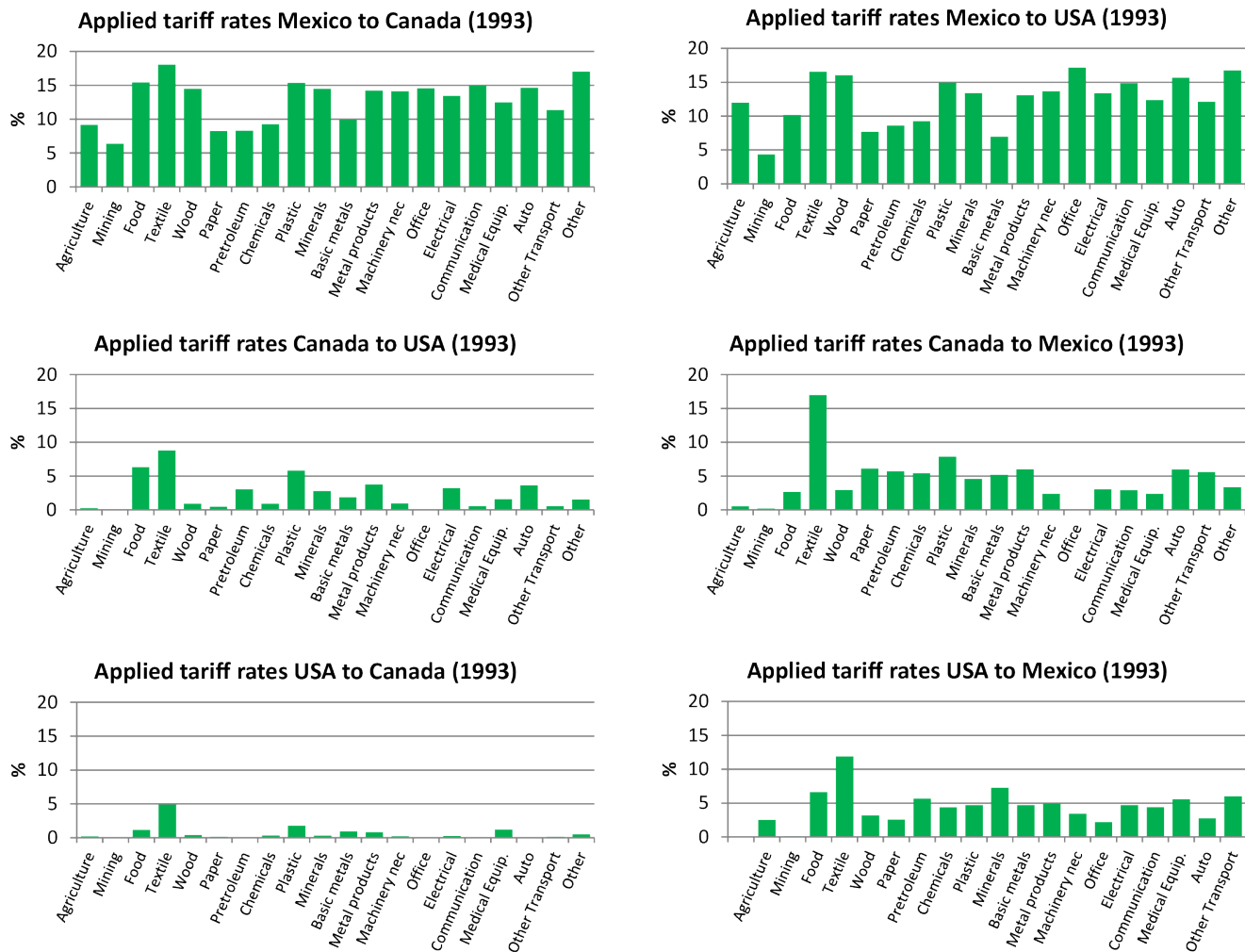
- **Trade in Goods:** Over a 15 year period, all tariffs and most non-tariff barriers on goods imports were eliminated. While some tariffs were eliminated immediately, certain ones were phased out gradually to allow time for certain industries to adjust. According to a study by Lorenzo Caliendo and Fernando Parro,²⁸ in 1993 sectoral tariff rates imposed by Mexico, Canada and the U.S. to NAFTA members were, on average, 12.5%, 4.2% and 2.7% respectively, with significant differences across sectors. **Figure 3** shows sectoral tariff rates for all three countries. By 2005, these rates dropped to almost zero between NAFTA members, while Mexico, Canada, and the U.S. applied rates of 7.1%, 2.2% and 1.7% respectively to rest of the world. The U.S. and Canada had fairly low tariff rates to start with. However, Mexico went through a significant reduction in its tariffs and quotas imposed on its NAFTA trading partners.

²⁶ Due to lack of comparable data for 1993 between 3 countries, 1992 Canadian report is used to highlight sectoral differences between three countries. Original source: "North American Free Trade Agreement: An Economic Assessment from a Canadian Perspective," November 1992, http://publications.gc.ca/collections/collection_2016/fn/F2-227-1992-eng.pdf

²⁷ Villarreal and Fergusson, 2017

²⁸ Lorenzo Caliendo and Fernando Parro, "Estimates of the Trade and Welfare Effects of NAFTA," The Review of Economic Studies, 82(1), pp. 1-44, 2015, <http://faculty.som.yale.edu/lorenzocaliendo/ETWENAFTEA.pdf>

Figure 3. Effective Applied Tariff Rates Before NAFTA



Source: Lorenzo Caliendo and Fernando Parro, "Estimates of the Trade and Welfare Effects of NAFTA," *The Review of Economic Studies*, 82(1), pp. 1-44, 2015, <http://faculty.som.yale.edu/lorenzocaliendo/ETWENAFTA.pdf>

- Some industries went through significant changes, including textiles and apparel (all duties phased out within 10 years if they meet certain rules of origin), the automotive industry (the Mexico auto decree was phased out and a rules of origin requirement of 62.5% was introduced for North American content for autos, light trucks, engines and transmissions), and agriculture (this is administered through bilateral agreements between the countries).
- Trade in Services:** Expanding certain provisions of CUSFTA, a basic set of rules and obligations was established. Nondiscriminatory treatment and access to information were granted to service companies.
- Foreign Investment:** Significant investment barriers were removed and basic protections for NAFTA investors were introduced. Also a dispute-settlement mechanism was introduced to resolve disputes between investors and a NAFTA country.
- Government Procurement:** There was a significant opening of federal government procurement in each country to suppliers from other NAFTA countries.

There were other important provisions including intellectual property rights and dispute settlement procedures in NAFTA that became the model for other FTA's for the U.S. Certain parts of the agreement were also used during the Uruguay negotiations.

IMPACT OF NAFTA OVER THE YEARS

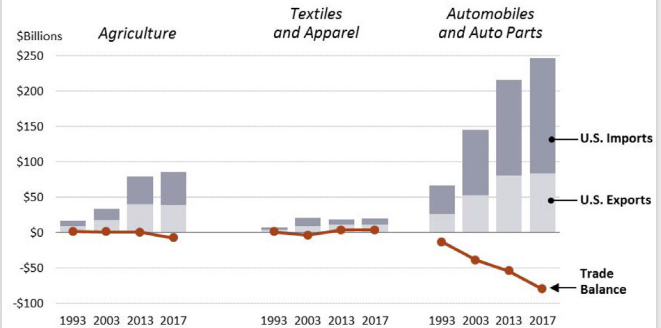
The USITC's 1993 economic analysis predicted that NAFTA was likely to produce net aggregate gains for each member country, both in short term and in the long term. Real GDP gains for the U.S and Canada were projected to be 0.5 percent or less over the long run. However, the impact on Mexico's real GDP was projected to be between 0.1 and 11.4 percent. NAFTA was also projected to significantly increase U.S. and Mexican trade. Wages were projected to increase 0.3 percent or less for the U.S., 0.5 percent or less for Canada, and a range of 0.7 to 16.2 percent for Mexico.

The report rightfully pointed out that the impact on the U.S. would vary from region to region, with border regions benefiting significantly. Certain industries, such as automobiles, apparel, flat glass and major household appliances, were expected to be negatively impacted by the agreement.

When we look at the existing evidence today, we see that trade between the three countries has boomed over the years. U.S. trade in goods (imports plus exports) with Canada and Mexico has increased from \$293 billion in 1993 to \$1.14 trillion in 2017, a 289 percent increase.²⁹ Over the same period, U.S. trade in services increased from \$44 billion to \$150 billion, a 240 percent increase. Overall trade in goods and services between U.S. and its NAFTA trading partners almost quadrupled, from \$337 billion in 1993 to \$1.3 trillion in 2017. According to the United States Trade Representative's website:

- In 2017, the top two destinations for U.S. goods exports were Canada and Mexico, accounting for 34 percent of all U.S. exports of goods and services, with Canada representing 18.3 percent and Mexico 15.7 percent. In the same year, Canada and Mexico were the second and third largest import source for the U.S., comprising 26 percent of total U.S. imports.
- According to CRS report,³⁰ the industries that were subject to the most liberalization (especially on the Mexican side) experienced the largest increase in trade. **Figure 4** shows U.S. trade with NAFTA partners in selected industries.

Figure 4. U.S. Trade with NAFTA Partners in Selected Industries (billions of nominal dollars)



Source: M. Angeles Villarreal and Ian F. Fergusson, "NAFTA Renegotiation and the Proposed United States-Mexico-Canada Agreement (USMCA)," February 26, 2019, Congressional Research Service, R44981. <https://fas.org/sgp/crs/row/R44981.pdf>

- NAFTA opened large markets for U.S. small businesses. According to research by the Small Business and Entrepreneurship Council³¹, in 2015 there were 89,106 firms that were exporters to Canada and 59,428 firms exporting to Mexico. 75.4 percent of the firms exporting to Canada and 72.7 percent of the firms exporting to Mexico had fewer than 50 employees.
- Another important economic variable that has seen a boost as a result of NAFTA is FDI. **Table 1** shows the FDI relations between U.S. and its two trading partners and how it has evolved between 1993 and 2017. Both before and after enactment of NAFTA, the U.S. continues to be the largest source of FDI in Mexico. U.S. investment went from \$15.2 billion in 1993 to \$109.7 billion in 2017. U.S. has a considerable FDI in Mexican manufacturing: In 2017, \$44.4 billion out of the total \$109.7 billion U.S. FDI in Mexico was in the manufacturing sector. It is widely agreed upon that NAFTA's provisions on foreign investment helped lock in Mexico's reforms and increase investor confidence, attracting steady stream of funds from the U.S.

²⁹ Office of the United States Trade Representative, <https://ustr.gov/countries-regions/americas/canada> and <https://ustr.gov/countries-regions/americas/mexico>

³⁰ M. Angeles Villarreal and Ian F. Fergusson, "NAFTA Renegotiation and the Proposed United States-Mexico-Canada Agreement (USMCA)," February 26, 2019, Congressional Research Service, R44981. <https://fas.org/sgp/crs/row/R44981.pdf>

³¹ Raymond J. Keating, "NAFTA: BIG Benefits for U.S. Small Businesses," SBEC, February 2018. <https://sbecouncil.org/2018/02/28/nafta-big-benefits-for-small-businesses/>

Table 1. U.S. FDI Positions with Canada and Mexico (1993 – 2017 historical cost basis)
(millions of dollars)

Year	Canadian FDI in the U.S.	U.S. FDI in Canada	Mexican FDI in the U.S.	U.S. FDI in Mexico
1993	40,373	69,922	1244	15,221
1994	41,219	74,221	2,069	16,968
1995	45,618	83,498	1,850	16,873
1996	54,836	89,592	1,641	19,351
1997	65,175	96,626	3,100	24,050
1998	72,696	98,200	2,055	26,657
1999	90,559	119,590	1,999	37,151
2000	114,309	132,472	7,462	39,352
2001	92,420	152,601	6,645	52,544
2002	92,529	166,473	7,829	56,303
2003	95,707	187,953	9,022	56,851
2004	125,276	214,931	7,592	63,384
2005	165,667	231,836	3,595	73,687
2006	165,281	205,134	5,310	82,965
2007	201,924	250,642	8,478	91,046
2008	168,746	246,483	8,420	87,443
2009	188,943	274,807	11,111	84,047
2010	192,463	295,206	10,970	85,751
2011	205,225	330,041	12,500	85,599
2012	214,314	366,709	12,751	104,388
2013	222,989	370,259	15,869	86,433
2014	273,896	370,220	15,198	94,482
2015	323,207	361,954	15,262	101,326
2016	380,730	365,375	17,209	100,734
2017	453,127	391,208	18,011	109,671

Sources: Compiled by ACCF using most recent data from the Bureau of Economic Analysis online database at “Direct Investment by Country and Industry”, <https://www.bea.gov/data/intl-trade-investment/direct-investment-country-and-industry>

Figure 5.A U.S. Merchandise Trade with NAFTA Partners: 1993-2017

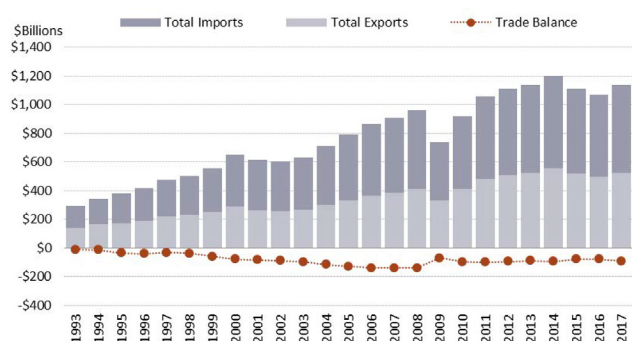
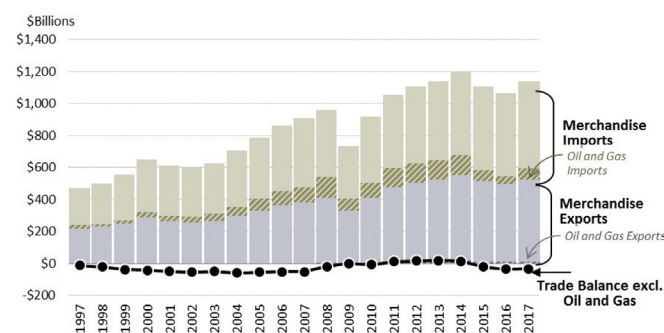
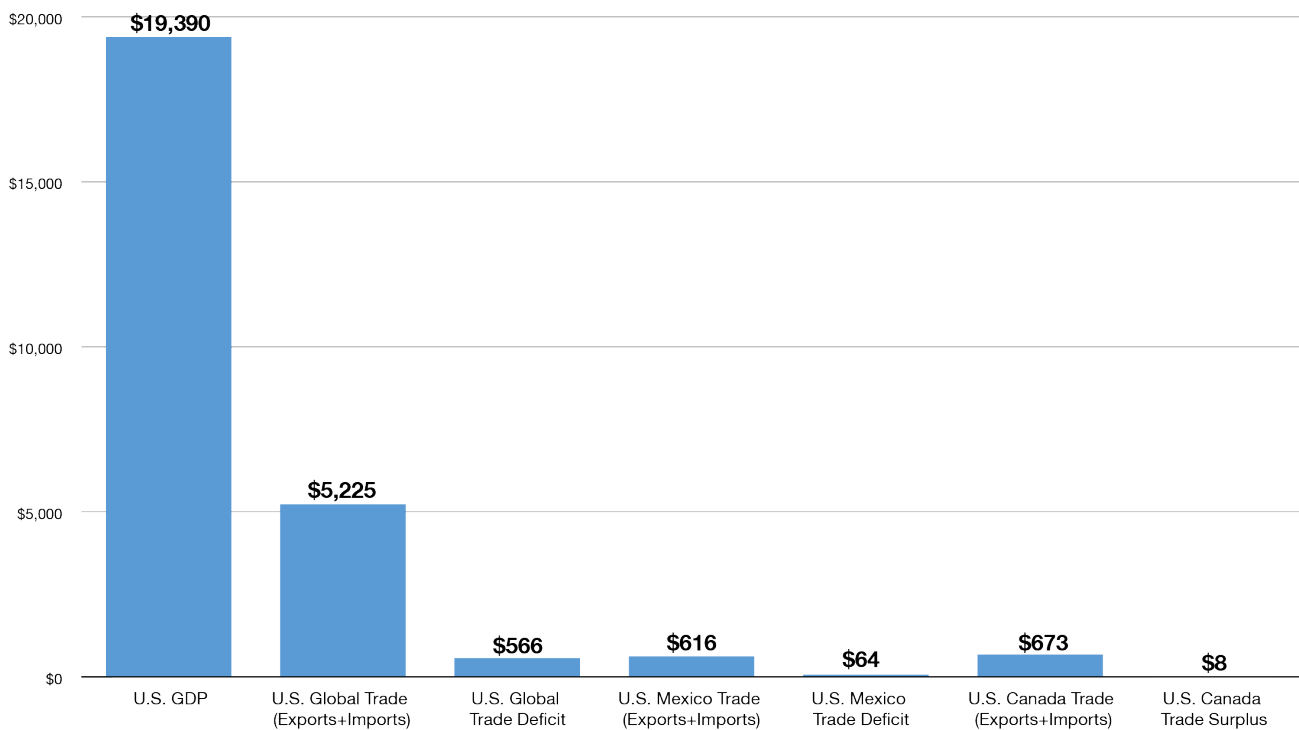


Figure 5.B U.S. Merchandise and Oil and Gas Trade with NAFTA Partners: 1997-2017



Source: M. Angeles Villarreal and Ian F. Fergusson, “NAFTA Renegotiation and the Proposed United States-Mexico-Canada Agreement (USMCA),” February 26, 2019, Congressional Research Service, R44981. <https://fas.org/sgp/crs/row/R44981.pdf>

Figure 6. U.S. Global and NAFTA Trade of Goods and Services in Context, 2017 (In Billions of \$)



Source: Author's Calculation using Department of Commerce, Census Bureau and USTR Data.

Figure 5a and b shows U.S. merchandise trade and trade balance with its NAFTA partners between 1993 and 2017, both including and excluding petroleum oil and oil products. While the US has an overall trade deficit for goods with its NAFTA partners, the deficit with either country is small relative to the size of the U.S. economy (See **Figure 6**).

An analysis of NAFTA over the years shows that many of the goals of the FTA were achieved, including increased competition, improved productivity, and cheaper products for consumers. Through a substantial network of supply chains intertwined in the three countries, U.S. value added now accounts for 40 percent of the value of U.S. imports from Mexico and 25 percent of the imports from Canada. To put that in perspective, U.S. value added is only 4 percent of the value of imports from China.³²

It is difficult to precisely measure the impact of NAFTA on the economies of the three countries given the multiple other factors in play, such as economic downturns, global financial crises, and the productivity gains in the U.S. in the mid-1990s, etc. However, a number of studies have tried to quantify the impact. Caliendo and Parro (2015)³³ found that the reduction of tariffs on goods boosted U.S. welfare by 0.1 percent of GDP. Similarly, a 2016 ITC report showed that all U.S. FTAs combined boosted U.S. GDP by 0.2 percent, with the majority of that increase coming from NAFTA.³⁴ Matthew Slaughter, who surveyed the existing studies, concluded that NAFTA increased U.S. GDP by a range of 0.2 to 0.3 percent. When converted to dollars, U.S. GDP is \$40 to \$60 billion higher than it would be without NAFTA.³⁵

32 Robert Koopman, William Powers, Zhi Wang and Shang-Jin Wei, "Give Credit Where Credit is Due: Tracing Value Added in Global Production Chains," September 2010, NBER, Working Paper 16426.

33 Lorenzo Caliendo and Fernando Parro, "Estimates of the Trade and Welfare Effects of NAFTA," *The Review of Economic Studies*, 82(1), pp. 1-44, 2015, <http://faculty.som.yale.edu/lorenzocaliendo/ETWENAFTA.pdf>

34 "Economic Impact of Trade Agreements Implemented under Trade Authorities Procedure," June 2016, U.S. ITC.

35 Matthew Slaughter, "How Withdrawing from NAFTA Would Damage the U.S. Economy," January 2018.

The increased economic integration was also reflected in employment and wages. For example, overall U.S.-Mexico trade data show that, on average, a 10 percent increase in employment at a Mexican affiliate operation leads to a 1.3 percent increase in U.S. employment, a 1.7 percent increase in U.S. exports, and a 4.1 percent increase in U.S. R&D spending.³⁶ According to Slaughter's survey, average wages in the U.S. increased by 0.2 to 0.3 percent as a result of NAFTA. This is also in line with prior research that shows how industries heavily involved in trade are associated with higher wages.

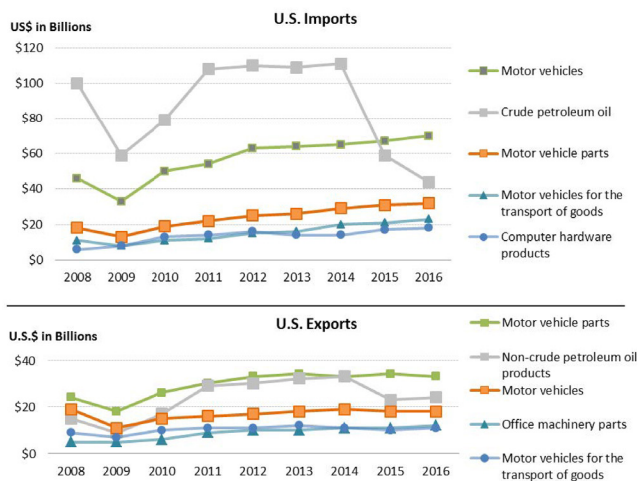
NAFTA AND KEY INDUSTRIES: A BRIEF LOOK AT AUTOMOTIVE INDUSTRY AND ENERGY SECTOR

Figure 7 shows the breakdown of the top five U.S. exports to and imports from NAFTA partners. As mentioned before, the success of U.S. Canada Automotive Products Agreement was one of the drivers for creating the CUSFTA. With the participation of Mexico, the North American trade in motor vehicles and parts became an integral sector in NAFTA. Figure 7 shows that, while motor vehicles are the top import for the U.S., motor vehicle parts are the top export.

According to a Boston Consulting Group study,³⁷ labor productivity in this sector increased significantly in all three countries. Figure 8 shows the evolution of employment and vehicle production per country between 1995 and 2016. According to data, the U.S. has seen the highest boost in output per employee, from 9.3 to 12.7 vehicles per employee, between 1995 and 2016.

The integration of the auto sector in North America was a natural result of comparative advantage: Cheaper labor in Mexico results in a higher share of manual tasks being performed in Mexico compared to the U.S. and Canada. On the other hand, employment in high wage engineering and R&D jobs are located in the U.S. and Canada. This has not been specific to North America. According to the Boston Consulting Group study, the same is true for Germany and Japan. Germany has integrated supply chains, with access to low cost imports from Eastern Europe. The recent passage of TPP will probably further this integration in Asia for Japan. NAFTA has been crucial for North America to remain

Figure 7. Top Five U.S. Imports and Export Items to and from NAFTA Partners



Source: M. Angeles Villarreal and Ian F. Fergusson, "The North American Free Trade Agreement (NAFTA)," Congressional Research Service, May 24, 2017, 7-5700, <https://fas.org/sgp/crs/row/R42965.pdf>

competitive in world markets by relocating parts of its auto manufacturing based on the cost advantages of three countries.

This integration in auto supply chains is also highly visible in the U.S. share of the value of imports. According to a recent study, while U.S. content of imported vehicles from Mexico was 5 percent before NAFTA, it is 40 percent today.³⁸

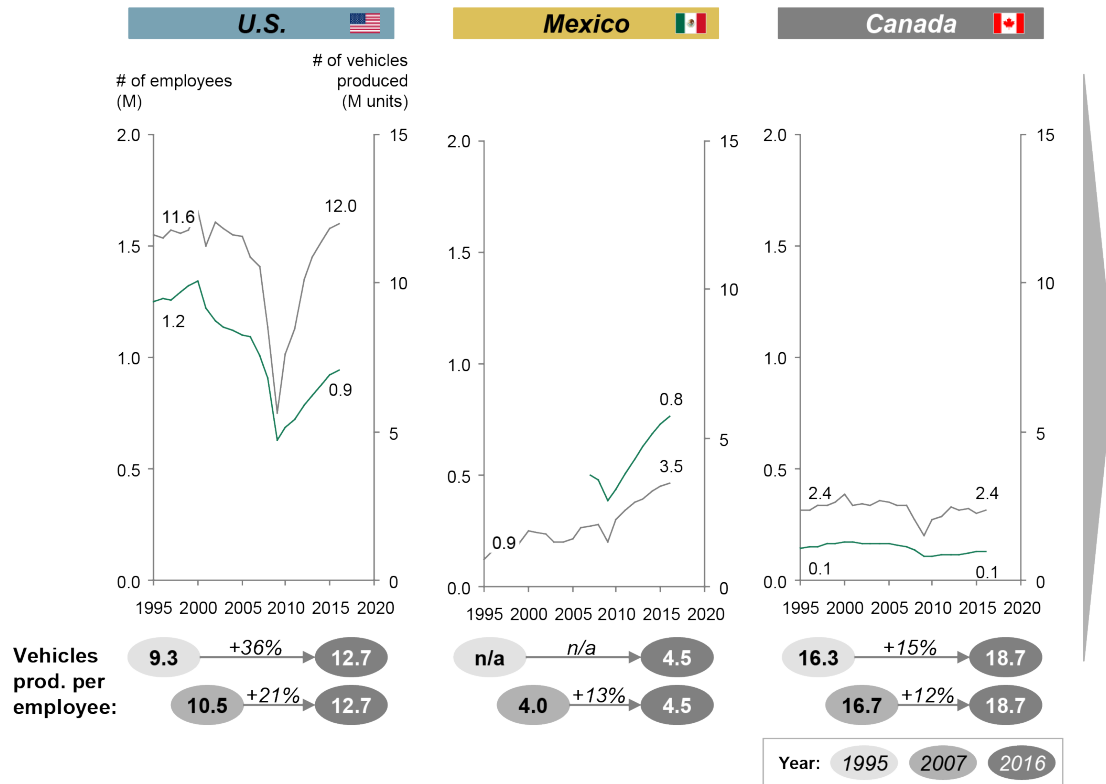
Another sector that is vital for North America that went through a major transformation during the NAFTA years is the energy sector. Like the auto industry, the energy sector represents a highly integrated market. Figure 9 showcases this integration through trade for different energy commodities between the three countries in 2017.

³⁶ Moran and Oldenski, 2014.

³⁷ "A World Without NAFTA: A Look at the Future Through the Lens of the Motor Vehicle Industry," October 12, 2017, The Boston Consulting Group. https://www.mema.org/sites/default/files/A_World_Without_NAFTA_0.pdf

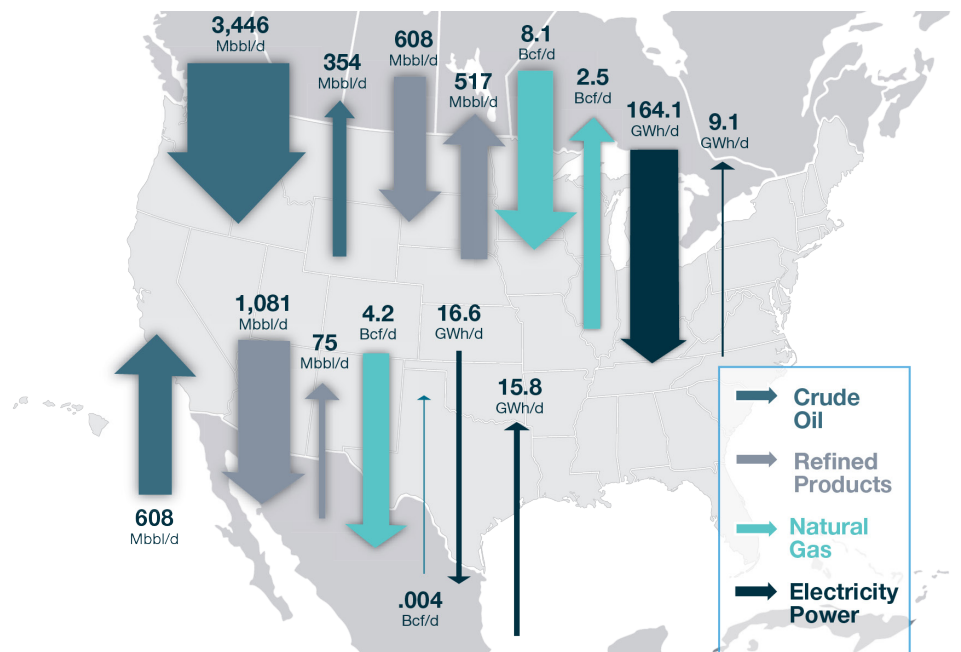
³⁸ "Nafta Briefing: Trade Benefits to the Automotive Industry and Potential Consequences of Withdrawal from the Agreement," Center for Automotive Research, 2017. http://www.cargroup.org/wp-content/uploads/2017/01/nafta_briefing_january_2017_public_version-final.pdf

Figure 8. Evolution of Employment and Vehicle Production per Country



Source: "A World Without NAFTA? A Look at the Future Through the Lens of the Motor Vehicle Industry," October 12, 2017, The Boston Consulting Group. https://www.memagroup.com/sites/default/files/A_World_Without_NAFTA_0.pdf

Figure 9. North America Energy Flows by Commodity, 2017



Source: "North American Energy," American Petroleum Institute, 2019, <https://www.api.org/-/media/Files/Policy/Trade/North-American-Energy-Onepager.pdf>

While Canada is the largest supplier of crude oil to the U.S., both Mexico and Canada are major buyers of petroleum products refined in the U.S.³⁹ The shale revolution in the U.S. has made natural gas a key component of increased energy trade, especially between the U.S. and Mexico. In addition to the shale revolution, the growth in natural gas fired electricity generation in Mexico (which lacks domestic natural gas production) made the U.S. their largest foreign supplier of natural gas.

The energy linkage between all three countries was further improved after the 2013 energy reforms in Mexico that allowed for private investment in this sector. These reforms, in combination with the investor protections in NAFTA, were instrumental for FDI by American companies in electricity transmission, purchases of oil and gas leases, as well as renewable production in Mexico. According to recent research, American oil companies have committed to \$6.5 billion worth of investment in Mexican oil and gas since the reforms went into place.⁴⁰

The cross-border energy cooperation is also apparent in building energy infrastructure, such as pipelines for oil and natural gas and transmission lines for electricity. The oil pipeline infrastructure in Canada and U.S. is fully integrated and a rapid growth in this infrastructure occurred between 2010 and 2015.⁴¹ All these changes and market forces over the years, as well as projections of future consumption and production, points to the possibility of North American energy self-sufficiency.

The energy cooperation between the three countries is also helping to keep greenhouse gas emissions down and could play an important role in the future. According to Mexican officials, Mexico, who chose to remain in the Paris Agreement, is increasingly dependent on U.S.-produced natural gas to keep its emissions low.⁴² According to a recent CRS report, both Canada and Mexico have potential to provide significant future supplies of renewable electricity to U.S. markets that could help to further reduce GHG emissions.⁴³

NAFTA RENEGOTIATIONS: STICKING ISSUES

Following the notification of Congress regarding the intent to renegotiate NAFTA, the three countries began the first round of discussion in early-fall 2017. It took nine rounds of discussions and further deliberations to reach to an agreement. The debate got tenser in the seventh round after President Trump introduced steel and aluminum tariffs of 25 percent and 10 percent, respectively, on the grounds of national security. While Canada and Mexico were originally excluded from these tariffs, the Administration decided to move forward and apply the tariffs to Canada, Mexico and EU at midnight on May 31st. Given that Canada was the biggest supplier of steel to the U.S., the issue had been referred to by some as the “elephant in the room” during negotiations. These punitive tariffs remain a big concern during the ratification stage of the final agreement.

During more than one year of back and forth deliberations, there were a lot of issues that surfaced between three countries. However, three major requests made by the U.S. Administration, driven by the Administration’s desire to reduce U.S. trade deficit, garnered most of the attention. These were:

- **Sunset Clause:** The U.S. had proposed a five-year “sunset clause,” that would automatically terminate the agreement unless all three parties agree to extend it. Canada and Mexico both rightfully opposed this clause since it would create major uncertainty each five years over the future of the agreement. Given that the majority of investment in the region is long term, associated with manufacturing, introducing uncertainty would dampen FDI flows within the three countries, as well as FDI into the region (and especially into Mexico) from other countries.

39 “Cross Border Energy Trade in North America: Present and Potential,” Congressional Research Service, January 30, 2017. <https://fas.org/sgp/crs/misc/R44747.pdf>

40 Lisa Viscidi and Rebecca O’Connor, “US-LATIN AMERICA ENERGY INVESTMENT Proposals for Policy Engagement,” May 2017. http://www.thedialogue.org/wp-content/uploads/2017/05/US-Latin-America-Energy-Investment_FINAL-for-web.pdf

41 “Cross Border Energy Trade in North America: Present and Potential,” Congressional Research Service, January 30, 2017. <https://fas.org/sgp/crs/misc/R44747.pdf>

42 “Mexico now dependent on US natural gas for hitting emissions targets,” Washington Examiner, June 23, 2017. <https://www.washingtonexaminer.com/mexico-now-dependent-on-us-natural-gas-for-hitting-emissions-targets>

43 “Cross Border Energy Trade in North America: Present and Potential,” Congressional Research Service, January 30, 2017. <https://fas.org/sgp/crs/misc/R44747.pdf>

- **Rules of Origin:** The U.S. Administration wanted to change the rules of origin for the automotive sector to “incentivize production in North America as well as specifically in the United States.” The U.S. rules of origin proposal called for a 50% U.S. domestic content requirement and a regional value content of 85%. However, both Canada and Mexico found the proposal unworkable. According to some experts, this could actually send production to Asia, since the costs of production in North America could be prohibitive with this change.
- **Weakening the Dispute Settlement System:** The U.S. proposed to allow parties to opt-in to the dispute settlement system, subject to conditions covering which companies can bring cases against foreign governments and limitations on what types of cases can be resolved under the provision. This would significantly weaken the system, by creating uncertainty regarding the fair treatment of investor assets in other countries, again weakening investment flows between the countries.
- **Increased access to Canada’s Dairy Market and U.S. sugar, peanuts and cotton market:** Both the U.S. and Canada commit to either reduce or eliminate tariff and quota limits to provide increased access to each other’s select agriculture products.
- **Investor State Dispute Settlement (ISDS):** The ISDS has been a staple of U.S. bilateral investment treaties since the original NAFTA. It is an arbitration system that allows private investors to pursue claims against a nation if there are violations of the investment provisions in the trade agreement. However, the proposed USMCA effectively ends the ISDS system between the U.S. and Canada and limits it to certain sectors between U.S. and Mexico (government contracts in natural gas, power generation, infrastructure, transportation and telecommunications.) In the case of direct expropriations, the ISDS will continue after first exhausting domestic remedies.
- **Sunset Provision in Review and Term Extension:** In line with the U.S. request, in the proposed USMCA the parties agree to review the agreement on the sixth anniversary of the agreement’s entry into force. If all parties agree to continue, the agreement will stay in force for an additional 16 years. If there is a disagreement about the additional 16-year term, the parties will conduct annual joint reviews.

WHAT IS IN PROPOSED USMCA?

On September 30, 2018, the negotiators announced they had reached a deal. According to many experts, the majority of the agreement is similar to the original NAFTA. However, there are some significant changes on autos and agricultural products, as well as changes to the dispute settlement system. The agreement also includes similar provisions that are in line with provisions that were negotiated by the previous Administration during deliberations on the Trans Pacific Partnership. These provisions include digital and intellectual property, patent protections, employment standards, environmental rules and currency manipulation. The new deal also encourages regulatory alignment in some sectors, such as agriculture, to increase efficiency.

Some key changes in the proposed USMCA, compared to NAFTA, include:

- **Rules of Origin:** The original 62.5 percent North American content requirement for autos, light trucks, engines and transmissions is upped to 75 percent.
- **Wage requirements:** USMCA requires that 40 to 45 percent of North American auto content be made by workers earning at least \$16 per hour. The goal of this provision is to move some of the auto industry jobs to the U.S. and Canada.

WHERE COULD WE END UP?

With the end of the deliberations between the three countries and the proposed trade agreement, the attention has shifted to Congress. While the Administration would like speedy action on implementing legislation under the Trade Promotion Authority (TPA)⁴⁴ that was approved in 2015, Congress might decide not to do so if they believe the President did not satisfy certain requirements outlined in TPA.

At the writing of this report, recent announcements from Democratic members requesting changes to the agreement have put a cloud over the future of the agreement. Speaker Nancy Pelosi has stated that President Trump should reopen trade talks with Canada and Mexico to tighten the enforcement mechanisms outlined in the draft agreement.⁴⁵ In addition, some members, including Speaker Pelosi, would like to see actual labor reform legislation finalized in Mexico before considering the proposed agreement. Faced with a potential lengthy ratification process, President Trump indicated that he would consider withdrawing from NAFTA in order to pressure Congress to ratify the USMCA. But there

⁴⁴ Under TPA if President satisfies the principal trade negotiating objectives and meets various requirements during and after negotiations, Congress will provide speedy procedures to ratify the agreement within 90 days.

⁴⁵ “Pelosi Demands Changes to Trump’s Trade Deal with Mexico, Canada,” The Washington Post, April 2 2019. https://www.washingtonpost.com/business/economy/pelosi-demands-changes-to-trumps-trade-deal-with-mexico-canada/2019/04/02/009874ca-556f-11e9-814f-e2f46684196e_story.html?utm_term=.bf70ead22bed

are questions about whether the President has the legal authority to withdraw from the agreement.

With many unknowns at this stage, we can look at existing research on two possible outcomes: What happens if we terminate NAFTA? What is the possible economic impact of USMCA? While there are various studies addressing the first question, the research on second question has just started to materialize. Starting with first question, if NAFTA were to be terminated it is unclear what would come next: Would the U.S. and Canada go back to CUSFTA or would that agreement be tabled as well? What tariffs would be applied between member countries?

Researchers have analyzed the possible impacts of terminating NAFTA both at the macro-level and at the industry-level, under a variety of assumptions about what comes next. A recent study, conducted by Joseph Francois and Laura M. Baughman,⁴⁶ shows that if NAFTA is terminated and most favored nation (MFN) tariffs are imposed for U.S. trade with Canada and Mexico, a net of 1.8 million U.S. workers would immediately lose their jobs across all sectors of the economy. U.S. economic output would fall 0.6% in each of the first five years after termination. The U.S. service sector would be hit the hardest, since it is the largest component of the U.S. economy.

François and Baughman also consider another scenario in which all three countries pick the maximum tariff rates that won't trigger World Trade Organization violations. Under that scenario, U.S. job losses would be 3.6 million with U.S. economic output decreasing 1.2% in short term. In the long run, after the economy adjusts, the impact would be 0.5% lower GDP.

Another study, conducted by ImpactEcon⁴⁷ (an economic consulting firm) using the same Purdue University model as was used by Francois and Baughman and the same MFN tariff rates, pegs the job loss at 1.2 million with a reduction in output of 0.6 percent. The job losses for Canada and Mexico are estimated to be 462,000 and 1.2 million, respectively, with reductions in GDP of 1.81% and 1.48%.

Various other consulting groups and banks have also conducted studies to estimate the potential impact of NAFTA termination. According to Bank of Montreal estimates, if tariff rates revert to MFN rates U.S. GDP would go down by 0.2 percent over five years and job losses would amount

to 0.1 percent.⁴⁸ An Oxford Economics Research Brief shows a 0.5 percentage point decrease in U.S. economic growth in 2019 without changing the U.S. trade deficit much, assuming MFN rates after termination.⁴⁹

Boston Consulting Group conducted a sector-level study⁵⁰ that analyzed the impact of NAFTA termination on the U.S. automotive industry. According to that study, withdrawing from NAFTA could cost 20,000 jobs in the automotive sector and another 25,000 to 50,000 jobs in the auto parts manufacturing sector. Termination of NAFTA is also estimated to increase the cost of a vehicle by between \$330 and \$440 in the United States.

The automotive industry is particularly interesting due to its long history with FTAs as discussed above. Changes in rules of origin requiring higher U.S. content, could increase production costs significantly. According to the Peterson Institute for International Economics study, "country specific rules could cause foreign companies to leave North America and export from their home regions. For example, Japanese producers might decide to export more from Japan

Table 2a. Impact of Terminating NAFTA on Non-NAFTA Trading Partners, MFN Tariff Rates

Year	GDP (percent)	Employment (thousands)
China	+0.16	+2,006.1
Korea	+0.35	+146.0
Japan	+0.24	+291.4
Germany	+0.20	+123.5

Table 2b. Impact of Terminating NAFTA on Non-NAFTA Trading Partners, Bound Tariff Rates

Year	GDP (percent)	Employment (thousands)
China	+0.07	+1,720.2
Korea	+0.33	+151.0
Japan	+0.64	+743.3
Germany	+0.52	+308.1

Source: Joseph Francois and Laura M. Baughman, "Terminating NAFTA: The National and State by State Impacts on Jobs, Exports and Output," January 2018, Trade Partnership Worldwide.

⁴⁶ Joseph Francois and Laura M. Baughman, "Terminating NAFTA: The National and State by State Impacts on Jobs, Exports and Output," January 2018, Trade Partnership Worldwide.

⁴⁷ ImpactEcon, "Reversing NAFTA: A Supply Chain Perspective," March 2017.

⁴⁸ Douglas Porter, "The Day After NAFTA, Economic Impact Analysis," November 2017, BMO Capital Market Economics. <https://economics.bmocapitalmarkets.com/economics/reports/20171127/BMO%20Economics%20Special%20Report%20-%20The%20Day%20After%20NAFTA.pdf>

⁴⁹ Oxford Economics, "Research Briefing U.S.: The Cost of Leaving NAFTA," Jan 2018.

⁵⁰ Boston Consulting Group, "A World Without NAFTA? A Look at the Future Through the Lens of the Motor Vehicle Industry," October 2017.

if the strict rule made production in Mexico less profitable. Vehicles imported from Japan have only 3 percent U.S./Canadian content on average, so demand for U.S. auto parts would fall.”⁵¹

It is also important to underline the potential impact on the US’s major competitors of terminating NAFTA. According to the Francois and Baughman study, terminating NAFTA and introducing MFN tariff rates, could increase employment in China by 2 million. **Table 2a and 2b** shows the impacts of terminating NAFTA on China, Korea, Japan and Germany assuming different tariff rates.

When we consider the possible economic results of USMCA on the U.S. economy, many experts believe the results will be small given that the agreement was not significantly different from NAFTA. One study,⁵² released by International Monetary Fund (IMF) in March 2019, validates this expectation. The analysis considers specifically the impact of five provisions that has changed between NAFTA and USMCA:

1. higher vehicle and auto parts regional value content requirements,
2. new labor value content requirement for vehicles,
3. stricter rules of origin for USMCA textile and apparel trade,
4. agricultural trade liberalization that increases U.S. access to Canadian supply-managed markets and reduces U.S. barriers on Canadian dairy, sugar and sugar products, and peanuts and peanut products, and
5. trade facilitation measures

The results of the paper shows that effects of the USMCA on real GDP are negligible. “Most of the benefits of USMCA would come from trade facilitation measures that modernize and integrate customs procedures to further reduce trade costs and border inefficiencies.”⁵³ Their results also show that tighter rules of origin could reduce vehicle production in North America, sourcing the vehicles and parts from outside the region as some experts previously stated.

Another scenario that was analyzed by International Monetary Fund economists in the same research shows that, in addition

to USMCA, ending U.S. tariffs on steel and aluminum and reciprocal elimination of Canadian and Mexican retaliatory import surtaxes would create larger gains for all three countries. This extension would increase the welfare gain for the Canada, Mexico and the United States by \$2.5 billion, to a total of \$3 billion.

The ITC report⁵⁴ includes a much deeper analysis of the USMCA and finds relatively small gains from the agreement. An upgrade from current NAFTA baseline to USMCA is expected to raise U.S. real GDP by 0.35 percent (\$68 billion) and employment by 176,000 jobs. The baseline includes trade policies that were still in place when USMCA was signed on November 30, 2018, such as the steel and aluminum tariffs, import tariffs on China and reciprocating tariffs imposed by China, EU, Canada and Mexico.⁵⁵ At the sectoral level, manufacturing and mining shows the largest increase in output and employment compared to the baseline (0.57 and 0.37 percent). Service sector employment increased by 0.09 percent, or 124,300 jobs.

One of the most important economic contributions of ratification of the USMCA that has not been analyzed is the increased certainty it may bring to North American markets. Even though the ITC’s USMCA analysis considers the certainty that will be achieved through clarification of certain issues that were lacking in the original NAFTA, such as e-commerce and data management, there is something to be said about the certainty the full agreement would bring for the overall North American economy which currently is functioning in limbo. U.S. actions on trade policy has undermined the value of trade agreements in creating certainty, especially during economic downturns. According to Jerónimo Carballo, Kyle Handley, and Nuno Limão,⁵⁶ “uncertainty has international spillovers that can be mitigated via credible international trade agreements such as NAFTA, which provided U.S. firms with valuable insurance against the widespread threat of a global trade war during the 2008 crisis. However, the credibility and insurance value of these agreements is being trumped by events such as Brexit, the renegotiation of NAFTA, and US threats of a trade war, which mark the start of a ‘trade cold war’.”

51 Caroline Freund, “A U.S. Content Requirement in NAFTA Could Hurt Manufacturing,” Peterson Institute for International Economics, September 2017. <https://piie.com/blogs/trade-investment-policy-watch/us-content-requirement-nafta-could-hurt-manufacturing>

52 Mary E. Burfisher, Frederic Lambert, and Troy Matheson, “NAFTA to USMCA: What is Gained?,” IMF Working Paper, March 2019. <https://www.imf.org/en/Publications/WP/Issues/2019/03/26/NAFTA-to-USMCA-What-is-Gained-46680>

53 Ibid, pg 23.

54 “U.S. Mexico Canada Trade Agreement: Likely Impact on the U.S. Economy and on Specific Industry Sectors,” April 2019, United States International Trade Commission. <https://www.usitc.gov/publications/332/pub4889.pdf>

55 According to the ITC Report (2019) “In addition, although the baseline for the Commission’s model incorporated certain additional tariffs related to U.S. section 232 and 301 actions, the Commission’s model did not measure the effects of these policy changes. Therefore, the results presented here reflect the effects of USMCA only. A similar simulation that excluded the additional tariffs related to U.S. section 232 and 301 actions from the baseline had similar results for effects of USMCA.” (pg. 117, footnote 241)

56 Jerónimo Carballo, Kyle Handley, Nuno Limão, “Trade cold wars and the value of agreements during crises,” March 2018, <https://voxeu.org/article/trade-cold-wars-and-value-agreements-during-crises>

CONCLUSION

NAFTA changed the North American economy by creating integrated supply chains and increasing productivity and economic activity in the region. According to many experts, the agreement has been a net positive for the U.S. and its partners, both in terms of output and employment. Terminating the quarter century old agreement could be a big mistake in an increasingly competitive world, putting the U.S. at a disadvantage. A better choice for all three partners would be to ratify the modernized USMCA agreement to bring it into the 21st century.





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