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The USMCA's Future in Context

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INTRODUCTION

As this series of reports is being concluded (June 2020), the date of entry in force of the USMCA and its initial implementation has been confirmed as July 1.[1] The first report in this series[2] provided an overview of the USMCA and an assessment of its strengths and weaknesses, which does not bear repeating. However, the USMCA will function in the context of other trade-related matters. Each of these could affect the success of the USMCA as a mechanism for encouraging investment, creating new jobs, and enhancing consumer welfare in North America. This report briefly considers what in the author's view are the most significant of these factors, including the Section 232 steel tariffs; the United States-China trade war; the emasculation of the World Trade Organization's dispute settlement system; the unpredictable nature of the U.S. and Mexican presidents; and the impact of the coronavirus pandemic.

I. SECTION 232 TARIFFS (STEEL, ALUMINUM, AND AUTOS)

Although the Trump administration in May 2019 lifted steel and aluminum tariffs imposed in 2018 on imports from Canada and Mexico, tariffs or quotas remain or have been re-imposed not only on imports from China but also those from producers in Argentina, Brazil, the EU, Japan, South Korea, and others. These tariffs increase the cost of manufacturing in the United States of products that use these metals, particularly autos but many others ranging from nails to home appliances, making them more expensive than competing goods produced in other countries (including Mexico and Canada). Proposed tariffs on auto and auto parts imports under Section 232 of the Trade Expansion Act have been continuously postponed by the Trump administration and may no longer be under serious consideration given the repeated delays in taking tariff action.[3] It may be that the trade agreement concluded with Japan[4] and the prospect of swift retaliation from the European Union encouraged the administration to reconsider; whatever the reason, a serious additional threat to the North American auto industry has to date been avoided.

As noted in the second report and elsewhere in this series, stricter auto and auto parts rules of origin under the USMCA,[5] including those designed to encourage a shift of protection from Mexico to the United States, will inevitably increase production costs in the United States and elsewhere in North America, raising vehicle prices for both local sales and exports. Thus, in the final analysis auto production in North America may have greater difficulty competing with producers in Asia and Europe who export their vehicles to North America, and as exports to foreign markets.

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II. U.S.-CHINA TRADE WAR AND ONGOING ECONOMIC RIVALRIES

The ongoing trade "war" with China—even though as of January 15, 2020, a truce was reached through a "Phase One" agreement[6]—has also increased the cost

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of many intermediate goods imported into the United States for domestic production, as well as for finished products that have become more expensive for U.S. consumers. The January 2020 agreement does not eliminate tariffs imposed by the United States on Chinese imports under Section 301 of the 1974 Trade Act since mid-2018, although it postpones additional tariffs and reduces some of those earlier imposed.[7] Unless unilaterally altered by the Trump administration, tariffs will remain indefinitely at 25% for about $250 billion of imports and 7.5% (down from 15% earlier) for another $120 billion worth.[8]

The heavily managed trade agreement commits China to purchase an additional $200 million worth of U.S. products each year for the next two years, including billions in natural gas and other energy products, and some $40 billion of agricultural products.[9] China has also agreed to provide additional protection against forced technology transfer, to improve protection of intellectual property,[10] and to improve U.S. financial institution access to the Chinese markets.[11] Still, even with the agreement the average tariffs on Chinese imports have increased to 19.3% from 3.0% two years ago and still affect two-thirds of all U.S. imports from China.[12] The accord seeks to increase Chinese purchases of American farm products as noted above, but some observers doubt that it will in practice do much more than restore the status quo before the trade war began.[13] With the advent of the Covid-19 pandemic, discussed in Part V, below, the chances of these targets being reached, at least in 2020, seem limited at best.

Despite what most believe to be a serious need to protect high-tech U.S. products and technology from Chinese national security threats, and to restrain China's rampant illegal subsidies, most such problems are left for a future Phase Two agreement to be negotiated in the at an unspecified future time (if at all). Nor does the agreement resolve the standoff between the United States and China over Huawei's attempts to market 5G telecommunications equipment throughout the world, sales of which are resolutely opposed by the United States.[14] Under the Phase One agreement, U.S. penalty tariffs will continue to disrupt supply chains for an extended period of time even for goods that have no national security implications, and will make some goods manufactured in the United States less competitive with their counterparts abroad, discouraging domestic consumption and—because of increased production costs—reducing U.S. exports of many products, particularly automobiles.

Although a more comprehensive settlement of China-United States trade frictions seems highly unlikely in the foreseeable future, even the Phase One agreement should help to free North American investors and workers to take fuller advantage of the potential benefits of the USMCA once the USMCA parties have more fully reopened their economies. Those enterprises again producing goods in China for export to the United States should realize that high tariffs on many Chinese goods are the new normal, and will exist for at least another year and perhaps much longer. This presumably means that many will seek alternative manufacturing sites in Vietnam, India, Mexico, or elsewhere. Mexico could benefit from these shifts if President Andrés Manuel López Obrador's anti-foreign investment policies do not scare them off, but in many instances supply chain changes will be costly and the higher production costs in alternative markets may increase the costs of both intermediate and final goods to consumers in North America.

More generally, in my view the economic and trade rivalries between the United States and China—particularly in the "Made in China 2025" areas where China seeks parity or even dominance, such as robots, artificial intelligence, semiconductors, and electric vehicles—can be expected to continue for at least the next three or four decades. This unpleasant fact makes the smooth functioning of the USMCA even more important for the parties and the economic well-being of their stakeholders.

III. EMASCULATION OF THE WTO's DISPUTE SETTLEMENT SYSTEM

As of December 10, 2019, the WTO's appellate body ceased to function; while three judges are required to hear each case, only one remained due to U.S. blocking of appointment and reappointments.[15] In my view, one would have to be an incurable optimist to believe that the ongoing dispute between most members and the United States regarding the alleged overstepping of the appellate body, particularly its alleged "diminishing rights and obligations" of WTO members[16] can be resolved in the foreseeable future. Various factors—including but not limited to the fact that the 164-member WTO makes decisions by consensus (meaning that not only the U.S. but such powerful members as China, India, and Russia must agree)—suggest that serious reform of the WTO, such as that which would be required in such areas as appellate body procedures, rules affecting antidumping and subsidies actions, designation of certain members (including China and India) as developing countries with special privileges, and more generally its ability to deal with non-market economies, are years away.

Another implicit vote of the U.S. lack of confidence in the WTO and endorsement of unilateral action is found in the U.S.-China Agreement, which contains none of the traditional provisions for third-party dispute settlement. Rather, the agreement's "bilateral evaluation and dispute resolution" mechanism[17] is no more than a bilateral consultation mechanism that would leave the United States, should it decide that China was not acting in good faith to implement the provisions of the agreement, to retaliate with yet more tariffs or other restrictions affecting U.S.-China trade.

It also seems clear that the Trump administration will continue to flout WTO rules in other ways, with its unilateral Section 232 actions based on dubious "national security" concerns imposing high tariffs on steel and aluminum, and with its Section 301 action against China without resort to the dispute settlement process. While the Airbus penalty tariffs were duly authorized by the WTO under its dispute settlement mechanism,[18] the planned retaliatory tariffs against French products relating to taxation of digital goods were not. Others may feel that they too can flout WTO rules without consequence, as China has been doing for years in the areas of illegal subsidies and intellectual property.

Under the original USMCA, the demise of WTO dispute settlement posed a serious risk for Canada and Mexico, since the USMCA dispute settlement mechanism was no better than NAFTA's Chapter 20 (which permitted the United States to block panels essentially at will). However, under the USMCA as revised December 10, 2019, this becomes somewhat more difficult.[19] Assuming that all three parties promptly appoint their rosters of panelists, and assuming that the United States plays by the rules, Canada and Mexico as well as the United States have a reasonable chance of establishing a functioning system for resolving trade disputes even though the WTO's mechanism is no longer operative.

IV. UNPREDICTABILITY OF THE CURRENT U.S. AND MEXICAN ADMINISTRATIONS

As is evident from other reports in this series, particularly with regard to Lopez Obrador's "Mexico First" energy policies[20] and the Trump administration's originally proposed drastic revisions to NAFTA,[21] neither government's actions in areas relating to intra-regional trade have achieved a high level of predictability. There is thus always the risk that one or both will take unexpected actions affecting regional trade and investment. Prior such occurrences include the Trump administration's threat in June 2019 to impose tariffs of up to 25% on all Mexican source imports if Mexico failed to take effective steps to counter illegal immigration from El Salvador, Guatemala, and Honduras to the United States via Mexico.[22] It seems likely that Mexico as well as other countries, whether allies or foes, will periodically be the targets of the Trump administration's unilateralist foreign policy, with economic sanctions or high tariffs being the result.

In late May 2020, these concerns [regarding AMLO's anti-investment policies] were reflected again in the Lopez-Obrador's administration's imposition of rules that could end the participation of private power generators in Mexico's electrical energy market. This could encourage European and U.S. energy companies with investments in Mexico to cease operations there and to seek international arbitration.

On the Mexican side, Lopez Obrador's decision immediately after taking office in December 2018 to cancel the Mexico City airport project and to postpone new oil leases for three years have raised concerns for actual and potential investors.[23] In March 2020, some citizens of Mexicali voted to halt construction of a giant brewery. While good arguments could be made that the water-starved Mexicali Valley was a poor place to locate a mammoth brewery, the suspect referendum approach, where only a small minority of local voters supporting Lopez-Obrador bother to cast votes, favored by Lopez-Obrador, once again caused serious concerns within the Mexican business community.[24] In late May 2020, these concerns were reflected again in the Lopez-Obrador's administration's imposition of rules that could end the participation of private power generators in Mexico's electrical energy market. This could encourage European and U.S. energy companies with investments in Mexico to cease operations there and to seek international arbitration under NAFTA (the investor state dispute provisions of which will remain available for three years after July 1) or under Mexico's bilateral investment treaties with Italy and Spain.[25] The anti-business investment climate could discourage new investment in Mexico at a time when it is desperately needed to strengthen the economy and create new jobs and exports, although it might convince some potential investors to establish or expand their facilities in Canada or the United States instead despite higher labor costs.

Given the ongoing challenges of governing both nations, the personalities of the two presidents, and the devotion of both to "America First" or "Mexico First" populism, it is almost certain that similar disruptive events will occur on one or both sides of the border in the future. If both governments can effectively deal with them when they arise, serious consequences may be avoided. However, it seems naïve to assume that Lopez Obrador will always defer to Trump whenever such events occur, as with the migration issue noted above and in the willingness of the Mexican government to back down when it was faced with proposals under U.S. USMCA implementing legislation for labor attaches that raised sovereignty concerns in December 2019.[26] Such risks therefore seem inevitable in the future, particularly if Mexico's economy, flat in 2019, deteriorates further in 2020, as now seems certain in light of the Covid-19 worldwide pandemic. Also, the complex and intrusive rapid response labor dispute resolution mechanism incorporated into the USMCA[27] could generate conflicts between the United States and Mexico should the United States use the mechanism as an excuse for restricting imports or should Mexican authorities object to alleged intrusions on Mexico's sovereignty.

Under such circumstances, the uncertainties that should have been largely resolved for North American investment and employment by the entry into force of the USMCA will not be entirely dissipated, particularly if Lopez-Obrador's opposition to private foreign investment and Trump's threats to Mexico persist.

V. THE CORONAVIRUS PANDEMIC

This report is not an appropriate place for a lengthy discussion of the ramifications of the Covid-19 pandemic for the USMCA or North American trade, in part because as of June 2020 it is impossible to predict the full impact. However, several salient points bear noting. First, the WTO has predicted that world merchandise trade in 2020 will fall by between 12% and 32% compared to 2019, with nearly all regions suffering double-digit declines. The impact is expected to be more pronounced in sectors with complex value chains, such as automotive products.[28] Thus, the highly integrated North American auto industry, already challenged by the USMCA's new and stricter rules of origin[29] and the temporary closure of many auto factories in North America due both to Covid-19 concerns and declining consumer demand, will face new and unexpected hurdles as a result of the pandemic.[30] Second, with at least 20 million people out of work in the United States alone,[31] and with a recession expected in all three NAFTA/USMCA parties, demand for many consumer products—including but not limited to automobiles—may be depressed for several years or more.[32] Unfortunately, it seems highly unlikely that the extreme economic and social destruction caused by Covid-19 will be fully rectified unless and until a vaccine for the virus or other preventative measures are widely available throughout North America,[33] developments that could also require a year or more.

Most significantly for the future of today's long supply chains, the pandemic, for which China has been widely blamed, has added substantial pressure for the "reshoring"(to the United States) or "nearshoring" (to Mexico and Canada) of supply lines that rely today on China (or in some instances other Asian countries). This is particularly critical for personal protective equipment, and pharmaceuticals and materials used in their manufacture. At the present time, estimates suggest that some 80% of active ingredients and 40% of finished drugs sold in the United States are sourced outside the United States, and China is the second-largest source of drugs imported into the United States (after India).[34]

This adds to the U.S.-China trade war and to other political, environmental, and economic pressures to bring supplies of these products—along with those that raise national security concerns—closer to home, with shorter supply chains confined to the United States or more sensibly to North America (where the three countries provide potential opportunities to diversify sources as well). Covid-19 thus may increase the percentage of U.S., Canadian, and Mexican total trade and investment that takes place within North America in the future and reduce the region's imports from elsewhere (as well as exports from the United States, in particular to China). Without the USMCA, this evolving process would have been even more costly and difficult to implement; with the USMCA it will still be challenging and economically disruptive but seems more likely to occur without causing as extensive long-term injury to the North American economies, their enterprises, workers, and consumers.

ENDNOTES

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2. David A. Gantz, *The United States-Mexico-Canada Agreement: Overview and Analysis*, Baker Institute Report no. 12.11.18. Rice University's Baker Institute for Public Policy, Houston, Texas, https://www.bakerinstitute.org/media/files/files/1f9f406a/bi-report-121118-mex-usmca.pdf

3. See David Lewder, "Trump Can No Longer Impose 'Section 232' Auto Tariffs After Missing Deadline, Experts," *Reuters*, November 19, 2019, https://www.reuters.com/article/us-usa-trade-autos/trump-can-no-longer-impose-section-232-auto-tariffs-after-missing-deadline-experts-idUSKBN1XT0TK (suggesting that under the 1962 Trade Expansion Act provision, the period for acting on the study that began in May 2018 expired as of November 14, 2019).

4. U.S.-Japan Trade Agreement, October 7, 2019 [not yet in force], https://ustr.gov/countries-regions/japan-korea-apec/japan/us-japan-trade-agreement-negotiations/us-japan-trade-agreement-text. The agreement does not mention autos and auto parts, but it may be that an understanding exists between the parties that such tariffs will not be applied.

5. These include regional content requirements increased from 62.5% to 75%; $16 minimum hourly wages for 40% of auto and 45% of light truck production; a requirement that 70% of the steel parts used in auto and auto parts production be derived from steel "melted and poured" in North America. While many would consider wage increases stimulated by the USMCA's labor provisions highly beneficial, if those provisions result in higher wage costs for auto and auto parts production, the finished product costs will also increase.

6. Economic and Trade Agreement Between the Government of the United States of America and the Government of the People's Republic of China, January 15, 2020, https://ustr.gov/sites/default/files/files/agreements/phase%20one%20agreement/Economic_And_Trade_Agreement_Between_The_United_States_And_China_Text.pdf.

7. See USTR, "United States and China Reach Phase One Trade, Agreement," December 12, 2019, https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/december/united-states-and-china-reach (stating that some $250 billion worth of Chinese imports will remain subject to 25% tariffs, and tariffs on another $120 billion of Chinese imports will fall to 7.5%).

8. See Chad P. Bown, "Phase One China Deal: Steep Tariffs are the new Normal," Peterson Institute, December 19, 2019, https://www.piie.com/blogs/trade-and-investment-policy-watch/phase-one-china-deal-steep-tariffs-are-new-normal.

9. U.S.-China Agreement, Chs. 3, 6.

10. U.S.-China Agreement, Chs. 1, 2.

11. U.S.-China Agreement, Ch. 4.

12. Bown, "Phase One China Deal."

13. See Josh Zumbrun and Kirsk Maltais, "China's Farm-Purchase Targets Under Trade Deal Face Skeptics," *Wall St. Journal*, December 18, 2019, https://www.wsj.com/articles/chinas-farm-purchase-targets-under-trade-deal-face-skeptics-11576665004 (suggesting that the $200 million export target could be achieved only if U.S. exporters sent 100% of their soy, oil exports, and liquefied natural gas to China).

14. See Steven Musil, Sean Keane, and Corinne Reichert, "U.S. Presses British Officials to Block Huawei from 5G Network," *CNET*, January 15, 2020, https://www.cnet.com/news/us-presses-british-officials-to-block-huawei-from-5g-network/.

15. See Keith Johnson, "How Trump May Finally Kill the WTO," *Foreign Policy*, December 9, 2019, https://foreignpolicy.com/2019/12/09/trump-may-kill-wto-finally-appellate-body-world-trade-organization/.

16. See Bryce Baschuk, "What's Next for the WTO After Sabotage by the U.S.," *Washington Post*, December 11, 2019, https://www.washingtonpost.com/business/whats-next-for-the-wto-after-sabotage-by-the-us/2019/12/11/db45de8e-1bd3-11ea-977a-15a6710ed6da_story.html.

17. U.S.-China Agreement, Ch. 4.

18. These tariffs reflect a longstanding dispute between the United States and the European Union over alleged subsidies of Airbus in the EU and Boeing in the United States. See David Lawder and Philip Blenkinsop, "U.S. and Europe Spar Over Next Stage of Aircraft Subsidy Dispute," *Reuters*, May 6, 2020, https://www.reuters.com/article/us-usa-trade-eu-boeing/u-s-and-europe-spar-over-next-stage-of-aircraft-subsidy-dispute-idUSKBN22I2B4.

19. Protocol of Amendment to the USMCA, December 10, 2019, https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement/agreement-between. See also Chapter 3 of this book for discussion of the changes.

20. See "The United States-Mexico-Canada Agreement: Energy Production and Policies," September 17, 2019, https://www.bakerinstitute.org/media/files/files/a7b744b6/bi-report-091719-mex-usmca-5.pdf.

21. Gantz, "Overview of the USMCA.".

22. David Nakamura, John Wagner, and Nick Miroff, "Trump Announces Migration Deal with Mexico, Averting Threatened Tariffs," *Washington Post*, June 7, 2019, https://www.washingtonpost.com/politics/trump-could-decide-over-the-weekend-to-hold-off-on-tariffs-white-house-official-says/2019/06/07/6adb7d86-892d-11e9-98c1-e945ae5db8fb_story.html.

23. David A. Gantz, *The United States-Mexico-Canada Agreement: Settlement of Disputes*, Baker Institute Report no. 05.02.19., Rice University's Baker Institute for Public Policy, Houston, Texas, https://www.bakerinstitute.org/media/files/files/d14a5a86/bi-report-050219-mex-usmca-3.pdf.

24. David Agren, "Mexican City Rejects Plans for Giant U.S.-Owned Brewery Among Water Shortages," *The Guardian*, March 23, 2020, https://www.theguardian.com/world/2020/mar/23/mexico-brewery-mexicali-constellation-brands.

25. See Jude Webber, "Mexico Rams Through Electricity Market Overhaul," *Financial Times*, May 15, 2020, https://www.ft.com/content/da6e5abd-b1b5-497f-9fff-f7c131c81b27?shareType=nongift

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27. See USMCA, Annex 31-A, "Facility Specific Rapid Response Labor Mechanism." A similar mechanism for potential labor disputes involving Canada and Mexico probably would raise fewer concerns; see Annex 31-B.

28. World Trade Organization, "Trade Set to Plunge as Covid-19 Pandemic Upends Global Economy," press release, April 8, 2020, https://www.wto.org/english/news_e/pres20_e/pr855_e.htm.

29. See USMCA, Ch. 2.

30. See "Rep. Kind: USTR Considering Flexibility for USMCA's Auto Terms," *World Trade Online*, April 14, 2020, https://insidetrade.com/daily-news/rep-kind-ustr-considering-flexibility-usmca%E2%80%99s-auto-terms ("Several industry groups and senators have warned that automakers and parts makers need more time to adjust to uniform regulations needed to guide the application of the complex automotive rules of origin. Those negotiations have faced delays due to technical issues as well as efforts to fight the Covid-19 pandemic, as some companies have shifted their focus to the manufacturing of medical goods. Many auto companies have also temporarily closed production facilities.")

31. Eric Morath and Sarah Chaney," *The Wall Street Journal*, April 16, 2020, https://www.wsj.com/articles/u-s-unemployment-claims-likely-continued-at-record-levels-11587029401.

32. See John Muellbauer, "The Coronavirus Pandemic and U.S. Consumption," *Vox CEPR Policy Portal*, April 11, 2020, https://voxeu.org/article/coronavirus-pandemic-and-us-consumption (suggesting that the impact of the Covid-19 will impose shocks on both supply and consumer demand that "are far grimmer than at any time in the 2008 global financial crisis").

33. See Lauren Krouse, "When Will the Novel Coronavirus Pandemic be Over?" *Women's Health*, April 28, 2020, https://www.womenshealthmag.com/health/a31406983/when-will-coronavirus-end/.

34. Yanz Huang, "The Coronavirus Outbreak Could Disrupt the U.S. Drug Supply," *Council on Foreign Relations*, March 5, 2020, https://www.cfr.org/in-brief/coronavirus-disrupt-us-drug-supply-shortages-fda.

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