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NAFTA Renegotiations: Constraints and Likely Outcome

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INTRODUCTION

For almost a quarter of a century, the North American Free Trade Agreement (NAFTA) has been the centerpiece of economic relations among all three countries in North America—the United States, Canada, and Mexico—and has, to a considerable extent, facilitated cooperation in other areas, such as security and law enforcement, as all three countries viewed the agreement as a symbol of a broader strategic partnership. Criticisms of NAFTA have never been entirely absent in the United States or Mexico— and are much less evident in Canada. However, since Donald Trump's arrival on the political scene there has been a heightened reexamination of the economic relationship among all trading partners. As candidate and now president, Trump has conducted a frontal assault on NAFTA. Candidate Trump declared in September 2016, for example, that NAFTA was "the worst trade treaty ever approved."[1] President-elect Trump said that Mexico had taken advantage of the United States.[2] Consequently, on May 18, 2017, Trump formally notified Congress that NAFTA was to be renegotiated.[3] The arguments justifying the revision of the agreement include the loss of jobs in the United States due to changing trade flows resulting from NAFTA (about 700,000, according to the U.S. Trade Representative[4]) and the trade deficit with Mexico (around $64 billion in 2016). The renegotiation of the treaty began in August 2017.

At the opening of the renegotiations, U.S. Trade Representative Robert E. Lighthizer explained U.S. objectives. They included the elimination of trade deficits in favor of a "balanced" and "reciprocal" trade relationship, revision of the rules of origin, reforms to the labor market in Mexico with the intention of increasing wages, measures against monetary manipulation, the elimination of mechanisms for resolving commercial disputes in favor of national judicial proceedings, and procurement of government contracts.[5]

In response, Mexico and Canada took similar—though not identical—positions, ones fundamentally against the more protectionist aspects of the Trump administration's renegotiation agenda. In fact, until August 2017, Mexico and Canada still believed that the renegotiation was an opportunity to "modernize" the treaty. For many, the modernization of NAFTA would include new provisions on rules of origin; the facilitation of trade at the borders and a review of customs processes; a further opening of the energy and telecommunication sectors; regulatory uniformity; access to government contracts at all levels; the integration of investment, financial, and services markets; new rules on intellectual property; the inclusion of electronic commerce in the treaty; and reconsideration of competition rules and environmental and labor measures.[6] The term "modernization" was controversial from the beginning, because modernization meant expansion of the agreement, which the United States did not seek, and thus the three countries did not appear to have

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the same definition of the term. Canada, like the United States for example, pushed for a review of stagnant Mexican wages—a step resisted by Mexico as detrimental to its development goals.[7] Canada also pushed for discussions on environmental and indigenous peoples' rights; the U.S. and Mexico were largely uninterested in these issues. The modernization agenda was also complicated by civil society organizations and economic actors in the three countries, as they viewed renegotiations as an opportunity to protect or advance their narrower interests.[8]

Although the three countries kept their negotiations largely secret in order to reach an agreement quickly,[9] the parties are so far apart that they have already announced that talks will have to go well into 2018.[10] Thus, faced with a prolonged debate on free trade in the U.S., dissimilar agendas from Mexico and Canada, and a looming presidential election in Mexico on July 1, 2018, the central question is: What is the most likely outcome of the negotiations?

THE PATH OF WHAT IS POSSIBLE: DISAGREEMENT IN PRINCIPLE

The outcome of renegotiations depends, theoretically, on the points of intersection of the three national agendas and the win sets resulting from the areas where the parties would be willing to make concessions.[11] This would require an agreement in principle—freer or less free trade, for example—and negotiations that go from there. In practice, however, the objectives of the United States are the starting point for NAFTA renegotiations. Consequently, because the United States' position is the narrowest of all and Mexico's and Canada's positions are relatively more expansive, the parties have essentially been far apart in all the rounds that have taken place so far.

The crucial factors running through the negotiations—and what narrows the path to a successful renegotiation—are the promises Trump made to his electoral base: to seek an American advantage in trade deals, to eliminate trade deficits, to re-shore and retain manufacturing jobs,

and to reinforce the sovereign institutions of the nation-state as the ultimate arbiter in trade disputes. These goals, outlined by USTR Lighthizer, dashed Mexico's and Canada's hopes of modernizing the treaty, although there may be some progress on certain issues—e.g., Mexico's energy sector or Canada's dairy industry. The Trump administration's goals have, in fact, moved Mexico and Canada to push to keep NAFTA as intact as possible. If Mexico and Canada want to save the agreement, there appears to be a narrow path to do so. However, given the relatively larger economic and political power of the United States, the two treaty partners will likely have to make some concessions to allow the Trump administration to claim political victory.

FIRST CUT: POLITICAL DIVERGENCE

An analysis of political differences among the NAFTA parties is essential to understanding the narrow path that successful negotiations must take. A successful renegotiation requires common values—the intrinsic benefits of free trade, for example, which has been a recurrent theme of U.S. international economic policy for decades. The Trump administration's stance toward free trade, however, marks a break from that of its predecessors. Instead, it bears a protectionist stamp, more in common with mercantilism than the economic liberalism that has driven the U.S. trade agenda under Democratic and Republican administrations alike.

In contrast, Canada has taken a clearer stance in favor of robust free trade. Mexico, however, has adopted a more complex, mixed position given its development imperatives—which include maintaining relatively low wages to bolster the competitiveness of its workforce[12]—and domestic political constraints.[13] This is the reason why Mexico's leadership has stressed the country's economic relationship with the United States as a path to development and is likely to make concessions to finalize negotiations as soon as possible. Clearly, Mexico—like Canada—is in general opposition to the position of the Trump

administration, which does not appear to value free trade in and of itself and seems to view trade negotiations as largely zero-sum transactions, but it faces important constraints of its own in carrying out successful negotiations.

SECOND CUT: THREE KEY ISSUES AND INTERSECTIONS

Political issues will no doubt help shape the outcome of NAFTA renegotiations—and thereby the future of trade in North America. This has already been playing out during the rounds of negotiations that have taken place to date. In fact, the most consequential outcome thus far— gridlock on key issues the United States has put on the table—has been the result of political calculations. This section addresses three of the most contentious: trade deficit reduction, wages in Mexico, and dispute resolution mechanisms.

Addressing Trade Deficits through NAFTA

The Trump administration has made reduction of the U.S. trade deficit, particularly with Mexico, a major goal of the renegotiations. This is a difficult goal to include in a trade agreement because trade deficits are the product of many other complex variables and may not even have a negative impact on the economy.[14] Trade deficits are the result of a host of decisions by private actors—from manufacturing firms to individual consumers—that may or may not conform to government objectives. Moreover, there are policies that governments can pursue to ease deficits while still avoiding protectionism.[15]

One way to reduce trade deficits through a trade agreement is to manipulate trade incentives through increases in import tariffs and other forms of protectionism. However, these are contrary to the spirit of free trade itself and will be costly, primarily to companies heavily engaged in crossborder trade and manufacturing, and to consumers who benefit from imported goods at no or very low tariffs. In other words, a negotiated trade balance through NAFTA implies the imposition of restrictions

on free trade within a free trade agreement. This is why some in Mexico and Canada argue that that no deal is better than a bad deal.[16] Canada has already said it could fall back on its 1989 free trade agreement with the U.S., and Mexico has suggested that it would retreat to World Trade Organization rules if negotiations fail. But Mexico and Canada will not leave the talks because a renegotiated NAFTA contains protectionist elements. They will stick to it if they believe they still benefit. They are not likely to exit on principle, even if they make concessions they believe are in violation of the spirit of free trade.

The irony of seeking to achieve "balanced" trade through an agreement is evident in the talks on agricultural goods. The U.S. has recently asked for seasonal limits on imports of Mexican agricultural products. Such a quota scheme is not only costly to American consumers of Mexican farm products, but it lends itself to retaliation. Mexico has already issued warnings on such limits, and it believes that its greatest leverage is precisely in agriculture, where it is a key market for American farmers.[17]

Addressing Mexican Wages and American Workforce Competitiveness

The second central objective presented by the Trump administration is an improvement in the competitiveness of U.S. workers, particularly in the manufacturing sector, through higher wages and better working conditions in Mexico. The Trump administration has essentially argued that Mexico has kept wages artificially low and made Mexican workers more competitive over their American counterparts. Thus, the U.S. president wants Mexico to raise its wages to even the playing field for American workers. Indeed, Mexico's salaries have remained much lower than those in the U.S. or Canada.[18] Mexico's position is that salaries and work conditions are a domestic issue best addressed by market forces, not by a trade agreement. On this, however, Canada and the U.S. Congress have decided to take the Trump administration's side and demand that Mexico improve salaries and

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working conditions for the country's labor force. If Mexico does not take a more flexible stance and offer concrete steps to legislate improvements in the well-being of the Mexican working class, the treaty is at risk.

Addressing the Elimination of International Dispute Settlement Mechanisms

A third objective of the United States is the elimination of Chapter XIX, which allows for the creation of binational panels that provide binding reviews of antidumping and countervailing duty rulings. The U.S. president prefers that disputes be resolved within domestic judicial systems. But Canada and Mexico view this mechanism as essential to fair outcomes in trade disputes, as they believe that U.S. federal courts and judges would not be fair. Canada, in fact, views Chapter XIX as essential if NAFTA is to be saved. For Mexico, these mechanisms are also a priority.

The Trump administration, however, values the primacy of sovereign institutions—U.S. courts—and is wary of supranational arrangements that constrain national sovereignty. Trump—a believer in the traditional state as the fundamental force for advancing the interests of its citizens—has expressed doubts on the desirability and wisdom of international institutions, including dispute settlement mechanisms.[19] Mexico and Canada's position is understandable, as dispute resolution mechanisms are especially important to countries that see themselves in weaker positions on international issues, including trade disputes.

THE FUTURE OF TRADE IN NORTH AMERICA

What do the political and practical issues examined tell us about the outcome of NAFTA? Considering these points simultaneously can help answer this question because together they suggest how far apart the parties are, not only in terms of the principle of free trade but also on the substantive details.

Most assessments agree that a win/win (or, rather, win/win/win) solution is a distant prospect.[20] Moreover, domestic politics will be as important as economic arguments. Unsurprisingly, there are signs that the leadership in all three countries understands that concessions will have to be made all around to ensure that all parties achieve at least partial political victory. This may explain why no one is willing—yet—to walk away from the talks; all parties have agreed to extend the timeline for renegotiations. This indicates that they will stay at the table until they find a solution whereby all can claim a "win," even if most concessions will be to the United States.

Trump—with low favorable ratings in the polls and a stalled legislative agenda—is in dire need of a political victory. Successfully renegotiating NAFTA will give him one. His NAFTA team will likely get concessions on nearly all issues, although they may fall short of initial U.S. demands. The United States will likely obtain pledges on Mexican and Canadian export restrictions to the United States. Mexico and Canada will also open up sectors where the United States stands to gain, such as e-commerce and government procurement, and further open their energy industries to U.S. businesses. The United States will also gain concessions on U.S. national content in manufacturing and force a Mexican pledge to revise its wage policy. Mexico and Canada could also make concessions on dispute mechanisms, perhaps by making them voluntary. Such concessions may be enough for Trump to claim victory. Whether such concessions will do much to address the president's broader goals—notably a U.S. economic revival based on a resurgence in manufacturing employment—is another question altogether. America's fundamental economic issues far transcend trade with Mexico and Canada.

The Mexican government also needs to end the negotiations quickly and claim its own political victory. There will be a contested presidential election in the summer of 2018, and the current front-runner is hostile to NAFTA. These political necessities will influence Mexico's timetable for talks; compromises will likely be rushed in early 2018. Mexico will accept higher U.S. content in its manufacturing sector, commit

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to some export restrictions in agriculture, promise to increase imports from the U.S. in areas such as energy and government procurement, and pledge to revise its wage policy. Similarly, Canada will make some concessions on soft wood, dairy products, and a few other areas. This may be politically difficult for Prime Minister Justin Trudeau, but he remains popular and may be able to gain tolerance from his constituents.

Negotiations may yet fail. NAFTA may still collapse. But the likeliest outcome is that, by mid-2018, all three parties will walk away with an agreement that allows them to claim a political victory. Thus, the most likely future for NAFTA is neither continuity—that is off the table as per U.S. goals—nor a "modernized" agreement that the U.S. does not appear to want. The probable result is an agreement that will include new areas but is in general more restrictive (less free, if you will), with the political interests of the Trump administration decisively shaping the final document. In the end, NAFTA will be saved—without common values between the Trump administration and NAFTA's two other partners—mostly because of political necessity. And Canada and Mexico will wait for a better day to "modernize" it.

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