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For Mexico, Canada, and the United States, a Step Backwards on Trade and Investment

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The negotiation of the US-Mexico-Canada Agreement (USMCA) has ended with sighs of relief over the fact that it could have been worse—but with limited expectations of new trade and investment opportunities for the United States or the region. The pact succeeds in partially updating the 25-year-old North American Free Trade Agreement (NAFTA) by imposing new obligations for enhanced environmental policies and labor practices, curbing state-owned enterprises, and fostering digital trade. These provisions improve incrementally but usefully upon the high standards for these policy areas developed in the Trans-Pacific Partnership (TPP), which the three countries signed onto during the Barack Obama administration, only to have President Donald Trump cancel the treaty in his first week in office. In these areas, not very contentious in North America, the provisions in the USMCA set some good precedents for future trade accords.

But NAFTA's benefits had always been primarily through the strengthening of economic integration of the three economies. Contrary to President Trump's claims, the new pact moves backwards in this critical regard and imposes new restrictions that will impede regional trade and investment, stifling the potential for economic growth. On autos, the deal is innovative in a perverse way: It is the first free trade agreement (FTA) negotiated by the United States that raises rather than lowers barriers to trade and investment. It adds layer upon layer of costly new regulations that producers must follow to qualify for NAFTA's low tariffs—layers virtually certain to drive up costs of autos for consumers and very likely reduce US jobs in the auto sector. Very simply, the pact is intentionally designed to mismanage the auto sector, an important driver of production and high-wage manufacturing employment in all three countries.

Based on analysis by the Peterson Institute for International Economics (PIIE), the new content rules and minimum wage requirements will likely lead to a less competitive North American auto industry with less investment in US plants and fewer US jobs in the sector—just the opposite of the claims of US officials. The new rules require that 75 percent of a car or truck have content made in North America to qualify for tariff-free imports, up from current level of 62.5 percent. In addition, 70 percent of steel and aluminum must be produced in North America, and 40 percent a car or truck would have to be made by workers earning at least $16 per hour, presumably to discourage companies from moving assembly operations to Mexico. Producers of passenger cars must either comply with the new rules or forgo the regional tariff preference. This will likely be their choice, since in that case they can use components from any country and simply pay the low most favored nation (MFN) tariff of

2.5 percent instead of rejiggering their supply chains. But truck producers don't have that relatively cheap escape hatch: The US MFN tariff on trucks is 25 percent.

As a result of these provisions, the cost of producing vehicles in North America will go up at a time when auto sales in the United States are slumping already. The slump reflects a long-term trend decline in auto demand, despite the booming US economy, due to changing demographics and consumer behavior. US production of vehicles will lose competitiveness vis-à-vis imported cars—unless the Trump administration decides to impose Section 232 tariffs on cars and parts to make European and Japanese imports more expensive. (Section 232 of the Trade Expansion Act of 1962 allows the administration to invoke national security to justify tariffs, without either congressional or World Trade Organization review, or economic justification.) Even then, the North American auto complex will lose competitiveness in terms of ability to export to other markets, which will be the only source of market growth as domestic demand declines.

The USMCA makes the imposition of such 232 auto restrictions more likely because US officials will need to close the MFN 2.5 percent loophole. The prospect for this happening is not unrealistic. The Trump administration's steel and aluminum 232 actions demonstrated how easy it is for the US government to circumvent MFN obligations and raise tariffs using specious national security claims. The Canadians and Mexicans saw it coming for autos and signed side letters to the USMCA that they expect will exempt them from possible 232 auto measures, making them complicit in the Trump administration's protectionist scheme to restructure global auto production and trade. But for the Trump administration, the ongoing threat of being able to impose such tariffs on Canada and Mexico even under the agreement is a feature not a bug, despite the chilling effect such uncertainty will have on investment in the North American auto industry.

The implications of the deal for other sectors are mixed and not very significant. The USMCA does remove some distortions in Canadian pricing schemes for dairy products, which should result in larger US dairy exports to Canada than those expected from TPP reforms. The amount of total reduction in barriers is very small. It also commits Mexico and Canada to raise the de minimis thresholds for applying duties on low-value shipments, removing nuisance duties applied to small US shipments, even though the level is still well below the US threshold.

Oddly, the deal does little to encourage trade in energy products. It also imposes additional criteria for duty-free trade in textiles and clothing and constrains access to bidding on government procurement contracts.

US dairy export gains, however, pale in comparison to the losses that continue to be borne by US farmers because of the barriers raised to US farm products by Canada and Mexico (and many others) in response to the Trump administration's aluminum and steel tariffs imposed earlier this year under Section 232. These aluminum and steel tariffs, dubiously justified under the rationale of national security, remain in place despite the new USMCA. The Trump administration should remove them before the USMCA is signed in late

November, which in turn would lead to Canada and Mexico reopening important markets for key US farm exports.

Another odd USMCA innovation involves its approach to investment "promotion." One advantage of trade pacts has been to create greater policy predictability so that investors can better plan their investment strategies without fear of being sideswiped by a sudden change in policy or regulation. The new USMCA turns that logic inside out. It attempts to encourage investors to choose the US market instead of its regional partners by creating greater uncertainty about the durability of the regional pact via several policy "reforms": instituting a new 16-year sunset clause, limiting access to investor-state dispute settlement procedures, and threatening or imposing new barriers to the US market for steel, aluminum, and potentially autos. This will over time diminish investment in the United States, even if it elicits a short-term boost in those limited sectors, just as similar provisions to shift investment have backfired in many developing countries.

Finally, the USMCA seeks to discourage Mexico or Canada from deepening formal trade and investment ties with China and other nonmarket economies. The pact obligates each signatory to notify the text of a deal with a nonmarket economy at least 30 days before signature to allow for review and assessment of the impact on the North American pact. Entry into force of the pact with a nonmarket economy is grounds for divorce, after a six-month notice. This provision is meant by the Trump administration to discourage other partners making deals with China, as Canada has been trying to do for several years. Mexico has had no interest in talking with China directly to date. But both Mexico and Canada are moving forward with the revised TPP and that could spell trouble for the new USMCA if China asks to negotiate accession to the Asia-Pacific pact.

All these steps add up to a step backwards on trade and investment in the United States and the region as a whole that, while not as damaging as it could have been, will do little or nothing to help workers, consumers, and the economies of North America.