THE OUTCOME OF NAFTA NEGOTIATIONS

By Elizabeth Orlando Senior Associate, Foreign Exchange, PNC

The North American Free Trade Agreement (NAFTA), a trilateral agreement among the United States, Canada and Mexico, is currently the largest free trade agreement in the world. One of the primary goals of the U.S. administration has been to renegotiate the terms or exit.
CURRENT TERMS UNDER NAFTA

In summary, the trilateral agreement that took effect in 1994 establishes the following key standards:

- The United States, Canada and Mexico must give each party equal treatment, including equal opportunity to investors, whether foreign or domestic, within these three countries. In addition, there must be no better deal offered to foreign investors outside of NAFTA. Federal contracts from each government must be available to both foreign and domestic businesses of these three countries.

- There are no tariffs between the three countries for many imports and exports that abide by NAFTA rules.

- Specific procedures are in place to resolve trade disputes so as to reduce costs related to lawsuits that would otherwise arise without such an agreement.

- All three countries must acknowledge patents, trademarks and copyrights within the North American region.

- Business travelers are granted easy entry and departure between the three countries.

UNITED STATES AND MEXICO

After Mexico’s presidential elections on July 1, 2018, a new urgency emerged for the United States and Mexico to resolve NAFTA issues. Mexico’s hope was to complete negotiations before President Enrique Peña Nieto leaves office on November 30, as the new president, Andrés Manuel López Obrador, has been more critical of the current trade treaty. The U.S. Congress needs formal notice 90 days before a new deal can be signed. For that reason, August 31 was the target date to complete negotiations.

On August 27, the United States and Mexico came to an agreement on several key issues, including rules related to tariffs and salaries in the automobile industry. One of the U.S. administration’s goals was to encourage automakers to bring manufacturing jobs back to the United States. Under the new agreement, there are three main rules in the automobile industry:

- For USMCA-traded automobiles, at least 75% of the content used in manufacturing must be from sources in the USMCA bloc, increased from 62.5%.

- At least 40–45% of manufacturing output for automobiles must result from workers earning at least $16 per hour.

- Any automaker that violates these rules will pay a 2.5% tariff, the same penalty for violations under the current NAFTA.

Before Canada rejoined the negotiations, the United States and Mexico had expressed interest in signing a bilateral agreement that the administration had named the United States/Mexico Trade Agreement. It is uncertain whether this would have been possible within the 90-day time frame, as it likely needed the support of Congress to commit to a deal that excluded Canada.
UNITED STATES AND CANADA

After the U.S. administration submitted the 90-day notice of intent to update the trilateral agreement, the pressure was on Canada to rejoin the negotiations or risk being left out of the deal. The next deadline was September 30, as any proposed changes had to be in writing at least 60 days prior to a new deal being signed. After several meetings during the month of September, trade representatives from the United States and Canada worked through the weekend and announced the new “United States-Mexico-Canada Agreement” late on Sunday night, September 30.

One of the main topics for the United States and Canada to resolve was dairy, and the new deal provides U.S. dairy farmers access to about 3.5% of Canada’s $16 billion annual dairy market. While Canadian dairy farmers aren’t thrilled about this update, this was in exchange for the U.S. administration’s agreement to leave Chapter 19, an independent tariff dispute settlement system, in place, which was a sticking point for Canada.

Other concerns for the two countries were intellectual property protections and the steel and aluminum tariffs that the United States imposed earlier this year. The United States fought for stronger intellectual property protections, which will come into effect under the new agreement. In regards to the 25% steel tariffs and 10% aluminum tariffs, these will remain in place and might be renegotiated at a different time.

UPDATING SUNSET CLAUSE

Prior to August, there was doubt whether a deal could be reached this year. That timing significantly changed when the United States and Mexico came to an agreement and especially when the United States updated the sunset clause.

Originally, the U.S. administration proposed that any agreement would only last for five years, and after this time frame had expired, the three nations would have to re-agree to continue the deal. This was a notable turning point in the negotiations; Mexico, Canada and many businesses were against this proposal.

One of the keys to the free trade deal is instilling confidence in companies that are making nondomestic manufacturing investments within the NAFTA bloc. Investors would be hesitant to build factories in one of the countries outside of their own if the future of tariffs between the three countries was unknown. If the United States hadn’t agreed to change this proposal, the trade negotiations could have potentially come to an end.

Instead, the three countries have agreed to a formal review in six years, and the soonest any country may withdraw based on that review is after 10 more years. Any problems found would trigger a new review each year until the problems are resolved. This provision encourages quick renegotiations for problems that previously tended to linger, yet the intention is for the trilateral deal to remain intact.

This provision was initially announced when the United States and Mexico came to an agreement, and it likely instilled more cooperation between the United States and Canada when they re-engaged in negotiations in September.
CURRENCY ACTION AND RISK MANAGEMENT

With a trilateral agreement remaining intact, there is less risk of significant economic costs for all three countries. While it looks like Mexico’s outgoing president, Enrique Peña Nieto, will be able to approve the deal for Mexico before leaving office, the treaty likely won’t be signed in the United States until 2019 by the new U.S. Congress, which could present new challenges to the agreement. A surprise during the approval process is something that could drive a multi-percentage-point move in the Canadian dollar, Mexican peso and likely many other currencies that react in times of global uncertainty.

It’s always hard to say if, when and to what extent a market reaction may occur. Just as events like Brexit and the Chinese renminbi devaluation were unexpected, preparing for volatility ahead of time is likely a better approach than trying to recover after a negative impact.

Companies may benefit from a dollar-cost averaging hedging approach. Leaving speculation aside and instilling a disciplined hedging policy could allow companies time to adjust should there be a drastic currency move. With much uncertainty ahead, it’s important to note that there are more strategies available before a market shock rather than after.

Effective Blended Rates for a Dollar-Cost Averaging Hedging Approach vs. the Spot Rate

In these graphs, the orange lines show the effective blended rates that would have been achieved with a dollar-cost averaging hedging approach compared to the blue lines, which show the spot rate. Source: Bloomberg

ABOUT THE AUTHOR

Elizabeth Orlando is a senior associate in PNC’s Foreign Exchange group. She specializes in providing risk management and international cash flow solutions for corporate clients. Orlando has a Bachelor of Science in commerce from the McIntire School of Commerce, University of Virginia, with a concentration in finance. She is licensed as a FINRA Series 7 General Securities Representative and FINRA Series 63 Uniform Securities Agent. She also holds a Certificate in International Cash Management (CertICM) from the Association of Corporate Treasurers.

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