

Autumn 2018

In May, Canadian Foreign Affairs Minister Chrystia Freeland was asked for an update on the trade agreement negotiations between the US, Mexico, and Canada. She used a surprising metaphor.

"When I was giving birth, one of my midwives said, 'You never know how long the labor will be, but you know that each contraction is one contraction closer to the baby being born.' And if I could use such a personal metaphor, that seems to apply to negotiations," Freeland told reporters. "We are definitely making progress. I am not going to predict the day and the minute and the hour that we will be finished."

If we continue Freeland's metaphor, the birth took place on September 30, when the US, Mexico, and Canada came to terms, and, in a truly uninspiring manner, named the agreement the United States-Mexico-Canada Agreement (USMCA). What do we know about this newborn? To truly understand, it's important to recognize it is the third-generation, with much of the same DNA, of a family of agreements conceived before, well, DNA. (The testing was invented in 1984, for the trivia buffs.)

Let's start with Grandpa CUSFTA.

Almost 40 years ago, President Reagan ran for office on the idea of creating a North American common market. Here's what he said in his remarks, announcing his candidacy for the Republican nomination: "Within the borders of this North American continent are food, resources, technology and underdeveloped territory which, properly managed, could dramatically improve the quality of life of all its inhabitants...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." It took nearly a decade, but Reagan achieved part of what he was after when, in 1988, he signed the Canada-US Free Trade Agreement (CUSFTA), which phased out, in stages and over ten years, a number of trade restrictions.

CUSFTA dramatically increased cross-border trade, but its time in the sun was brief. A few years after the signing of the deal, President George H.W. Bush was in trade negotiations with Mexico when, in 1991, Canada requested a trilateral agreement. This led to the birth of the North American Free Trade Agreement (NAFTA), which superseded its father. The treaty was signed by President Bush in December of 1992, his last month in office, and signed into law by President Clinton a year later. (So, whether you've been a friend or foe of NAFTA, you have two presidents, one from each side of the aisle, to hold responsible. Further evidence of the bi-partisan embrace of NAFTA? Clinton's signing was attended by Presidents Bush, Ford, and Carter.)

NAFTA had seven specific goals-grant most-favored nation status to all signatories, eliminate barriers to trade, promote conditions of fair competition, increase investment opportunities, provide protection and enforcement of intellectual property rights, create procedures for resolution of trade disputes, and establish a framework for further expansion. While controversial in some circles, the treaty has been in place for 25 years. Which brings us back to Minister Freeland, one of the politicians who helped midwife NAFTA's successor (assuming, as expected, the agreement is inked).

The USMCA is not the grand "brand new" trade agreement President Trump campaigned on. Its specific goals are largely the same as its predecessor's. But there are a few significant changes that are worth noting, and may give some credence to Prime Minister Trudeau's claim that the agreement was "a good day for Canada" and President Trump's that it is "a great deal for all three countries."

The biggest of those will occur in the automobile industry, which makes up about 25% of Mexico's total exports and 20% of Canada's. Previously, the US was contemplating a 25% tariff on these imports, but the new agreement will allow "free trade" in this arena, so long as some new restrictions are met. USMCA changes the North American source content from 62.5% to 75% (plus separate rules for auto parts). This will limit auto manufacturers from buying cheaper parts from countries outside the treaty. Additionally, 40% of assembly and other expenditures must be from "high-wage" (\$16 or more per hour) facilities. (Mexico grudgingly conceded to this stipulation, and also agreed to new labor laws aimed at strengthening union membership and collective bargaining.) In return, the US increased their caps on imported vehicles from both Mexico and Canada to 2.6 million autos and SUVs, about 40-50% higher than existing quotas.

The take-away? Mexico and Canada don't need to be concerned with the possible 25% tariff the US is considering imposing on all imported autos and component parts. (The current tariff is 2.5% for most imported autos.) And the higher source content and increased wages will cause manufacturers to adjust their methods and keep more manufacturing jobs in North America.

While much remains the same in terms of transportation (the borders are open) and agriculture (Mexico will be able to keep the supply of fruits and vegetable flowing), the US has won increased access into the Canadian dairy, poultry, and egg markets. This, after Canada already opened those markets to the European Union earlier this year, has Canadian farmers up in arms. But the effect should be minimal since the two countries currently consume about 80% of their domestic production. The US also expanded their pork and corn-based sweeteners markets, which will help offset any ill effects from the Chinese trade dispute.

Speaking of China, perhaps the most significant asset of the USMCA is that it creates a blueprint for future trade negotiations with the country. With the North American agreement behind us, attention will be returned to that contentious trade dispute-the US's imposed tariffs, and China's retaliation. While the precedence set by USMCA will be helpful, the battle over intellectual property rights and reciprocal fair and open markets in China will be arduous. That uncertainty will certainly impact investors behavior.

But, remember, it's not in US or Chinese interests to escalate or prolong this battle. Eventually, the two countries will come to an agreement, and the markets will pick right back up where they left off. As Minister Freeland said, each contraction is one contraction closer to the baby being born. We may see the birth of something entirely new. More likely, it will be a child of the familiar, modernized and renamed.