WHAT'S NEXT FOR NAFTA?

Introduction

The North American Free Trade Agreement ("NAFTA") was signed on December 17, 1992. After approval procedures and signing into law by the three partners, as appropriate, it has been in effect since January 1, 1994.

The market opening provisions of the agreement gradually eliminated all tariffs and most nontariff barriers on goods produced and traded within North America over a period of 15 years after it entered into force. The agreement included safeguard provisions in which the importing country could increase tariffs, or impose quotas in some cases, on imports during a transition period if domestic producers faced serious injury as a result of increased imports from another NAFTA country.

NAFTA services provisions established a set of basic rules and obligations in services trade among partner countries. However, there were certain exclusions and reservations by each country. These included maritime shipping (United States), film and publishing (Canada), and oil and gas drilling (Mexico).

Although NAFTA liberalized certain service sectors in Mexico, particularly financial services, which changed its banking sector profoundly, other sectors were barely affected. However, NAFTA did not require parties to authorize a person of another NAFTA country to provide or operate telecommunications transport networks or services. NAFTA did not bar a party from maintaining a monopoly provider of public networks or services, such as Telmex, Mexico's dominant telecommunications company. Mexico has unilaterally liberalized its telecommunications sector recently. Please see our client update: "Telecommunications Reform Implementation."

In addition to market opening measures through the elimination of tariff and non-tariff barriers, NAFTA incorporated numerous other provisions, including foreign investment, intellectual property rights, dispute resolution, and government procurement.

NAFTA's provisions for preventing and settling disputes created a system of arbitration for resolving disputes that included initial consultations, submitting the issue to the NAFTA Trade Commission, or following through arbitral panel proceedings. NAFTA included separate dispute settlement provisions for addressing disputes over antidumping and countervailing duty determinations.

The United States, Canada and Mexico addressed labor and environmental concerns entering into formal side agreements. The North American Agreement on Labor Cooperation

("NAALC") and the North American Agreement on Environmental Cooperation ("NAAEC") entered into force on January 1, 1994, the same day as NAFTA.

In addition to the two trilateral side agreements, the United States and Mexico entered into a bilateral side agreement to NAFTA on border environmental cooperation. In this agreement, the two governments committed to cooperate so as to develop environmental infrastructure projects along the U.S.-Mexico border to address concerns about the degradation of the environment along such border due to increased economic activity. The agreement established two organizations to address these concerns: the Border Environment Cooperation Commission ("BECC"), located in Ciudad Juárez, Mexico, and the North American Development Bank ("NADBank"), located in San Antonio, Texas.

President-elect Donald Trump has called to renegotiate NAFTA so as to incorporate substantial changes, or altogether depart from the same. The exact extent of such changes remains unclear.

Although we believe an outright departure from the agreement by the United States is unlikely to occur, we think that substantial changes to the agreement are likely.

NAFTA Impact

Trade among the NAFTA partners has more than tripled since the agreement took effect. It has increased more rapidly than trade with the rest of the world. In 2011, trilateral trade among NAFTA partners reached the $1 trillion threshold. Since 1993, total U.S. trade with Mexico increased more rapidly than total trade with Canada and trade with non-NAFTA countries. In 2014, Canada was the leading market for U.S. exports, while Mexico ranked second. The two countries accounted for 34% of total U.S. exports in 2014. In imports, Canada and Mexico ranked second and third, respectively, as suppliers of U.S. imports in 2014. The two countries accounted for 27% of U.S. imports. [1]

Many economists and other observers have credited NAFTA with helping manufacturing industries of the three partners, become more globally competitive through the development of supply chains. Much of the increase in U.S.-Mexico trade, for example, can be attributed to specialization as manufacturing and assembly plants have reoriented to take advantage of economies of scale. As a result, supply chains have been increasingly crossing national boundaries as manufacturing work is performed wherever it is most efficient. A reduction in tariffs in a given sector not only affects prices in that sector but also in industries that purchase

[1] See M. Angeles Villarreal and Ian F. Ferguson, *The North American Free Trade Agreement*, Congressional Research Service (April 10, 2015).

intermediate inputs from that sector. The importance of these direct and indirect effects is significant. These linkages offer important trade and welfare gains from free trade agreements and ignoring these input-output linkages could underestimate trade gains.

The NAFTA partners, however, have not achieved all the goals they originally set in connection with the agreement.

A number of studies have found that NAFTA has brought economic and social benefits to the Mexican economy as a whole, but that the benefits have not been evenly distributed throughout the country. The effects of NAFTA in Mexico were limited by the fact that NAFTA was not supplemented by complementary policies that could have promoted a deeper regional integration effort. These policies could have included improvements in education, industrial policies and investment in infrastructure. One of the more controversial aspects of NAFTA is related to the agricultural sector in Mexico and the perception that NAFTA has caused a higher amount of worker displacement in this sector than in other economic sectors. It is estimated that these losses were over 1 million lost jobs in corn production. However, while some of the changes in the agricultural sector are a direct result of NAFTA as Mexico began to import more lower-priced products from the United States, many of the changes can be attributed to Mexico's unilateral agricultural reform measures in the 1980s and early 1990s. Most domestic reform measures consisted of privatization efforts and resulted in increased competition. Measures included eliminating state enterprises related to agriculture and removing staple price supports and subsidies. The unilateral reforms in the agricultural sector make it difficult to separate those effects from the effects of NAFTA. One should note, however, that new jobs which require higher skills and provide better pay have been created in Mexico as an effect of NAFTA implementation.

We understand that Canada's goal of achieving greater productivity has been less than entirely attained.

Many economists and business persons generally view NAFTA as a success and credit it for fostering unprecedented North American trade and creating job growth in the United States and Mexico. They look to build on NAFTA's momentum to improve trade relations and economic integration within the region. However, labor groups and some consumer-advocacy groups argue that the agreement has had negative effects. They maintain that the agreement resulted in outsourcing and lower wages that have had a negative effect on the U.S. economy and that as mentioned before, it has caused job dislocations in Mexico, especially in agriculture.

Experts consider that at most, 5 percent of dislocated U.S. workers can be traced to imports from Mexico. Additional job opportunities and higher wages have been offered as a result of NAFTA and other factors. This is consistent with the fact that export jobs are considered to pay, on average, 18 percent higher wages than nonexport jobs.

On a separate but related matter, the World Economic Forum estimates that by 2030, the U.S. will need to add 25 million workers to maintain growth. Some of such workers might be Mexican seasonal workers. The US may draw on the experience of the Canada-Mexico Seasonal Agriculture Worker Program for work force development purposes in connection with such need.

To the extent the Mexican economy improves as a result of integration between the U.S. and Mexico, the agreement will be a positive force for higher income, better living standards in Mexico and diminished immigration to the U.S. (already a noticeable trend).

There is a general consensus that implementation of a strategy for economic, energy, security, work force development, environmental and social cooperation among the three NAFTA partners can strengthen each of them at home and enhance its positive influence abroad. Most proponents and critics of NAFTA agree that the three countries should look at what the agreement has failed to do as they look to the future of North American trade and economic relations. Policies could include strengthening institutions to protect the environment and worker rights; fostering the implementation of a border infrastructure plan; increasing regulatory cooperation; promoting research and development to enhance the global competiveness of North American industries; investing in more border infrastructure to make border crossings more efficient; creating more efforts to lessen income differentials within the region; promoting education, including among other technical schools to increase a trained work force; and addressing fundamental security concerns, including the need to impose and effectively enforce regulations that will restrict the ability of Mexican cartels to purchase, smuggle and use assault weapons made in the United States against Mexican security forces.

NAFTA Outlook

What's next for NAFTA? President-elect Trump's "Seven Point Plan to Rebuild the American Economy by Fighting for Free Trade" involves among other key action items:

To "tell NAFTA partners that we intend to immediately renegotiate the terms of that agreement to get a better deal for our workers. If they don't agree to a renegotiation, we will submit notice that the U.S. intends to withdraw from the deal".

The following alternatives are available for the NAFTA partners in view of such circumstances:

(a) to renegotiate NAFTA focusing as suggested before on what NAFTA has failed to do;

(b) should the U.S. decide to depart from NAFTA, Canada and Mexico would need to focus on their own internal markets, as well as on other trade agreements each has in place;

(c) some of the three partners may seek to join in a new international trade agreement including more countries.

On the first alternative, the three partners could address some NAFTA issues through side understandings without changing NAFTA.

With respect to the second alternative, Article 2205 of NAFTA expressly allows any of the partners to withdraw from the agreement, provided that it gives a six-month advance and written notice of withdrawal to the other parties. We understand that in the view of experts, it is unclear whether Mr. Trump could withdraw from NAFTA without the support of Congress. NAFTA is a congressional-executive agreement and was implemented by Congress through the NAFTA Implementation Act, which is silent on termination. Mr. Trump's withdrawal from NAFTA would not automatically terminate the NAFTA Implementation Act. We further understand that the U.S. Supreme Court has held that proposals to amend or repeal statutes must be presented to and considered by both the House and Senate. The U.S. Congress could in theory formally oppose withdrawal from NAFTA. Such a response would likely leave it to the U.S. Supreme Court to decide the question over the course of the next few years. [2]

Should the United States depart from NAFTA, Mexico should focus on its own internal market, as well as on the 12 foreign trade agreements involving 43 countries (without counting the United States) it has in place, and should diversify its trading partners.

Concerning the third alternative, some of the partners may seek to join a trade agreement similar to the Trans Pacific Partnership ("TPP") put in the intensive care unit for the moment, or similar to the Regional Comprehensive Economic Partnership ("RCEP"), a mega-regional agreement that covers 16 markets, from India to Japan, being currently proposed by China.

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We will keep you posted regarding developments on this matter. Please do not hesitate to contact us at any time with questions that you may have about how changes to NAFTA may affect you.

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December 13, 2016

[2] See Debevoise & Plimpton, *The Outlook for Financial Regulatory Reform Under President Trump*, Client Update (Nov. 30, 2016).