NAFTA modernization: A mixed bag for the middle market

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NAFTA modernization represents something of a mixed bag for middle market businesses. The new treaty, dubbed the United States-Mexico-Canada Agreement (USMCA), includes an important chapter dedicated to small and medium-size enterprises and a wide array of provisions from the abrogated Trans-Pacific Partnership (TPP) trade treaty, which represent major wins for the middle market.

It also includes requirements for improved labor practices, environmental policies, facilitation of digital trade, cross-border trade in services, protection of intellectual property and a reduced role of state-owned enterprises. In our estimation, the chapters covering these substantial trade areas have created a positive framework for future modernization and a precedent for subsequent trade accords.

However, these gains are countered by other stipulations that may directly affect middle market businesses. They include renegotiation of so-called auto rules of origin up to 75 percent from 62.5 percent and the imposition of a wage floor of $16 per hour on 30 percent of autos produced. The production amount rises to 40 percent of vehicles by 2023 if an auto is manufactured with 70 percent steel and aluminum produced in North America. Those wage production thresholds will result in higher vehicle and parts pricing, as well as a subsequent erosion of the existing discount of roughly $5,000 per vehicle for all autos produced and purchased within the North American supply chain. In addition, we will see a modest rollback of the deep economic integration of the three economies—the United States, Canada and Mexico—organized around auto production.

Meanwhile, nothing in the treaty encourages an increase in energy market trade, which is a conceivable future point for further liberalization and modernization of the agreement. More problematically, the aluminum and steel tariffs put in place on both Canada and Mexico earlier in 2018 were not removed. These tariffs will continue to offset any gains associated with giving the U.S. agricultural sector greater market access.

The inclusion of almost all modernizations agreed upon during the Trans-Pacific Partnership negotiations, which was abandoned in early 2017, is an undeniable positive; however, additional layers of costly regulation and a move toward managed trade rather than free trade inside the North American auto chain will result in less efficient allocation of scarce resources and higher prices for all businesses that participate. Most importantly, the burden of adjustment related to production will fall squarely on the shoulders of middle market producers in the United States, Canada and Mexico, with the firms in Mexico bearing a disproportionate burden.

Section 32.10 of the agreement pinpoints the U.S. strategic position with respect to global trade; it states that if any party in the new trilateral agreement enters into a free trade agreement with a nonmarket economy, other parties in the existing agreement would have the option of terminating the agreement. Essentially this represents a “poison pill” that will severely curtail the ability of Mexico and Canada from entering trade agreements with China. This limitation is part and parcel of the larger ongoing trade dispute between the United States and China and likely indicates that future trade treaties will contain similar constraints as the United States attempts to curtail the ability of the world’s second-largest economy from further penetrating the North American trade bloc.

The full treaty, subject to language verification, is comprised of 34 separate chapters, 13 annexes and 13 side letters. The following provides a quick summary and analysis of those chapters that most affect the middle market economy.
Small and medium enterprises—Chapter 25

The text regarding small and medium enterprises sets up a mechanism to support efforts to increase trade and investment opportunities for businesses of this size and a formal oversight to ensure that large firms do not squeeze them out as they pursue participation in the global economy. It marks the first inclusion in a multilateral trade treaty of formal language ensuring fair participation in trade and investment for small and medium-size enterprises. A similar provision in the United States–Korea Free Trade Agreement (KORUS) spurred exporting across a variety of sectors in the middle market economy.

The treaty also sets up cooperation among parties to support small business infrastructure, including dedicated subject matter expert (SME) centers, incubators and accelerators, export assistance centers and other centers as appropriate. In addition, it creates an international network for sharing best practices, exchanging market research and promoting SME participation in international trade, as well as business growth in local markets.

The oversight within the chapter intends to set up an ongoing dialogue with representatives meeting at least once a year to discuss SME experiences, as well as best practices in supporting and assisting SME exporters. In addition, all three parties to the treaty will support and facilitate training programs, trade education, trade finance, trade missions, trade facilitation, digital trade, identification of commercial partners in other parties and the establishment of good business credentials.

Rules of origin—Chapters 4 and 5

The predominant driver of current trade policy is an attempt to repatriate global supply chains back to the United States. The modernization of NAFTA is likely to fall short of that lofty goal. However, the rules-of-origin chapters represent its formal expression. Unfortunately, they will likely result in higher costs for consumers and producers. Their inclusion denotes the first trade treaty entered into by the United States that formally increases trade barriers, rather than reducing them, and ultimately will result in a loss of auto production jobs across all three economies.

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The structure of the agreement as it pertains to the North American auto supply chain likely serves as an incentive for firms to make further investment closer to global growth areas in China and India. Moreover, with respect to the internal dynamics within the North American supply, the wage floor stipulation will almost certainly result in a pulling forward of automation and robotics within the region’s auto supply chain, which is already among the most technologically advanced in the international economy.

In the near-term, there may be a reduction in auto exports, especially lower-priced vehicles, from Mexico into the United States, as well as price hikes across the entire industry ecosystem. Over the medium term, however, as firms adjust to managed trade rather than free trade, further automation is highly probable. With price increases already factored in for consumers, the result will be a loss of competitiveness for middle market firms that feed into the North American auto supply chain.

In our estimation, rather than moving supply chains back to the United States, companies such as Volkswagen (VW), which export affordable autos for many U.S. and Canadian households in the lower- and middle-income strata, will simply pay the 2.5 percent tariff and pass the cost on to the consumer. The current base price of a VW Atlas, a family-size SUV, is $30,750; it will increase by roughly $768, resulting in a 15 percent net reduction in the average $5,000 discount now enjoyed by consumers who purchase an American-made auto. This does not include any impact from higher costs of production implied by the treaty, which will surely reduce that discount further.

The U.S. auto market is somewhat stagnant: the United States has not surpassed sales volume of 18 million vehicles on an annual basis for the past 20 years. It makes little sense for auto producers to bring production back home to a market that, in population-adjusted terms, is falling. Rather, they will almost certainly, under the newly managed trade format, look to make new investments closer to the growth markets of Brazil, China and India.

Auto suppliers will face difficult choices under the new agreement. Consider a firm that produces glass in Mexico and feeds its product into the North American automotive and housing supply chains. The company must either lift wages to meet the new wage floor or choose to move toward 100 percent automation. A business such as this will likely choose to focus on retaining higher-paid, value-added employees, release lower-paid workers and then move to automate, resulting in lower production costs and the ability to continue supplying the wealthy U.S. and Canadian markets. The result of the agreement will be greater automation and a reliance on robotics in all three economies, with respect to the productions of autos and automotive parts.

One of the more disappointing aspects of the new agreement is that it appears to be designed to complement an industrial economy that once existed in United States. That economy is slowly shrinking relative to the fast-growing new economy organized around sophisticated technology. With most products used in auto production crossing the border an average of six times before they wind up in a vehicle, it is virtually impossible to place a value on origin, which does imply that the expectations on production and job gains in the auto sector are not well-aligned with empirical reality. More importantly, the agreement does not appear to have considered advances in the use of data, artificial intelligence and machine learning in the production of autos and other manufactured goods.
Textiles and apparel—Chapter 6

The chapter addressing textiles and apparel is vague and will require further interpretation, subject to language verification. It does, however, promote greater use of U.S.-produced fabrics and yarn and calls for enhanced Customs enforcement of non-NAFTA-produced goods through third parties. This provision represents a rollback of free trade and market-derived pricing; it will, over time, likely increase the probability of the erection of nonmarket barriers to trade that will increase overall costs of production and consumption.

The text appears to reduce the ability of apparel makers to utilize non-NAFTA materials, which, if implemented, will certainly result in higher costs of production and thinner margins for those companies, depending upon the textile and apparel supply chains along the U.S.-Mexico border. To gain preferential treatment under the new trade agreement, manufacturers will be required to incorporate unspecified inputs made in the same region as the finished products. Specific language applies to coated fabric, narrow elastic bands, pocketing fabric and sewing thread. To put this in context, a dress shirt produced in Mexico must use goods made in the United States, Canada and Mexico.

Chapter 6 is one of the most highly technical chapters of the entire treaty and will require an in-depth investigation to provide greater clarity on the impact of the apparel and textile supply chains. One thing that is clear—goods imported from outside the North American trade bloc will face higher duties, thereby increasing the cost of production. This represents another move by the U.S. administration to limit the ability of Chinese exporters to find further market opportunities inside the North American economy.

Other provisions

Modest changes in other chapters, including the inclusion of much-hyped access for U.S. dairy businesses to the Canadian market, represent the adoption of provisions already agreed upon under the TPP. While these provisions do reduce some market distortions on the Canadian side of the border, the increase in total dairy exports from the United States to Canada will be quite small and in line with the TPP.

De minimis thresholds that apply to low value shipments were reduced. Meanwhile, nothing in the treaty encouraged an increase in energy market trade, which is a conceivable future point of further liberalization and modernization of the agreement. As mentioned above, the aluminum and steel tariffs put in place on both Canada and Mexico earlier in 2018 were not taken out. These tariffs will continue to offset any gains associated with giving the U.S. agricultural sector greater market access.