HOW TO PREPARE FOR THE OUTCOME OF **NAFTA NEGOTIATIONS**

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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 Trump administration has been to renegotiate the terms or exit.

The future of NAFTA was uncertain for the first eight months of this year. Now that negotiations have continued, and the United States and Mexico have come to an agreement, it seems likely that the United States and Canada will reach a deal, and the trilateral agreement will be updated with new terms. On August 31, the United States administration submitted a letter to Congress that is intended to serve as "notification of intent" to modify NAFTA in 90 days.

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 United States 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 administration's goals was to encourage automakers to bring manufacturing jobs back to the United States. While no written agreement has been released, the United States and Mexico are said to have agreed to three main rules in the automobile industry:

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

While negotiations are ongoing with hopes to include Canada, if Canada and the United States can't reach a deal, the United States and Mexico have expressed interest in signing a bilateral agreement that the administration has named the United States/Mexico Trade Agreement. It is uncertain whether this would be possible within the 90-day time frame, as it likely needs the support of Congress to commit to a deal that excludes Canada.

UNITED STATES AND CANADA

There are several issues to be resolved between the United States and Canada:

- Dairy is a significant part of Canada's economy and is currently excluded from the original NAFTA deal that removes tariffs on many other products.
- Chapter 19 and Chapter 11 are provisions related to disputing unfair trade practices. The United States prefers to eliminate Chapter 19 while Canada wants to keep it. Chapter 11 was renegotiated between the United States and Mexico, and Canada's stance on this has yet to be reported.
- Canada wants the United States to remove the tariffs on steel and aluminum.
- The United States is concerned about intellectual property protections.
- Canada wants better environmental protections related to climate change.

UPDATED 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 United States administration proposed that any agreement would only last for five years, and after this time frame 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 a 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, United States Trade Representative Robert Lighthizer reported that the United States and Mexico 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.

Canada may push for a longer time period before the formal review of the trilateral agreement, but it seems this new proposal has instilled more cooperation between the United States and Canada.

> Most importantly, the United States is now unlikely to withdraw from NAFTA, which would have resulted in significant economic costs for all three countries.

CURRENCY ACTION AND RISK MANAGEMENT

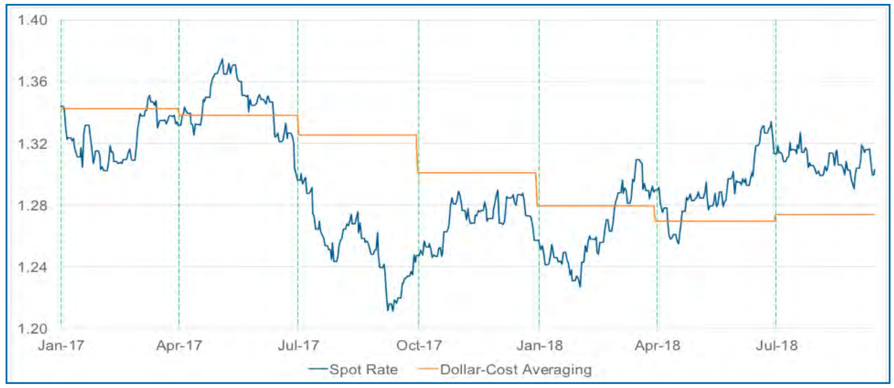
A surprise in NAFTA negotiations is something that could drive a multipercentage-point move in the Canadian dollar, Mexican peso and likely many other currencies that react in times of global uncertainty.

With the same issues continuing for the majority of this year, it's 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.

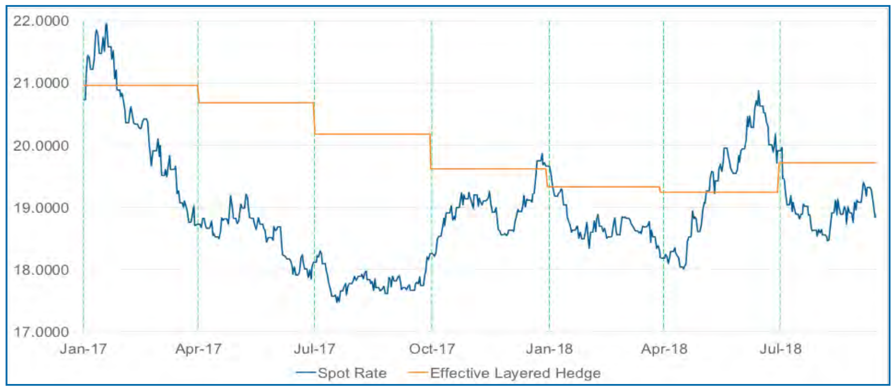
Companies may benefit from a dollar-cost averaging hedging approach. Leaving speculation aside and instilling a disciplined hedging policy could allow companies time to adjust should there be a drastic currency move. With much uncertainty ahead, it's important to note that there are more strategies available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

EFFECTIVE BLENDED RATES FOR A DOLLAR-COST AVERAGING HEDGING APPROACH VS. THE SPOT RATE

USD/CAD HISTORICAL RATES



USD/MXN HISTORICAL RATES



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

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