The ABCs of USMCA

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After more than a year of discussions, negotiators from the U.S. and Canada worked through the weekend to arrive at an 11th hour agreement for Canada to join Mexico in an updated NAFTA deal. The new name of the accord is the United States-Mexico-Canada Agreement, or USMCA.

We increase the likelihood that a new NAFTA deal will be implemented from 60% to 85% thanks to the tentative agreement. However, there are still a number of hurdles:

- The governments of the U.S., Canada and Mexico still need to vote and approve the pact – something that may prove more challenging in the U.S. if the Democrats gain control of the House of Representatives after the mid-term elections.
- The details of certain chapters still need to be ironed out.
- Complexities are often known to arise during the late stages of trade negotiations or during the ratification period.

Scenario	Odds	Details	Economic effect
NAFTA terminated	2%	• **NAFTA/USMCA scrapped** • Default WTO tariffs apply • Trade war possible as result? 3-5x worse	Problematic: • U.S. GDP -0.2 to -0.4% • Cdn GDP -0.4 to -0.8% • Mex GDP -0.6% to -1.4%
New USMCA deal	85%	• **USMCA deal slightly weakens trade** • Auto sector: quotas, 75% domestic content minimum, higher sector wages • Steel and aluminum tariffs still in place • Sunset clause, but 16 years minimum • Harder to negotiate China trade deal? • Trade dispute tribunals mostly unaltered • Unchanged cultural exemptions • Unchanged gov't procurement rules • Stronger IP rights • Canadian dairy sector weakened • Higher cross-border shopping limits • Modernization	Neutral to modestly negative economic effects
Prior NAFTA remains	13%	• **Original NAFTA remains in place** • White House changes mind • 2019 Democratic House fails to approve	Prolonged uncertainty; no long-term effect

Source: Moody's, RBC GAM.

Let's take a look at some of the key elements of the deal that have changed.

Autos

To avoid tariffs, and as previously agreed to between the U.S. and Mexico, 75% of auto production must take place within North America (up from 62.5%), with 45% of labour being paid at least $16 per hour. In addition, Canada also agreed to a maximum quota on auto and parts exports. But because the limits are over 40% above current levels, the quotas don't present any current constraints. However, they could become problematic should auto exports grow in the future.

Blanket tariffs

The existing tariffs on steel and aluminum will remain in effect for Mexico and Canada, a detail that is of particular concern for Canada since we are the largest single exporter of these items to the U.S. Fortunately, side negotiations are currently ongoing that seem likely to free the countries from these barriers.

China

Revealing the level of animosity between the U.S. and China, the new agreement seeks to limit the ability of Canada and Mexico to negotiate a free trade agreement with China by requiring a country to give notice if it enters into trade talks with a non-market economy. This will also protect the negotiating power of the U.S. by limiting China's ability to bypass U.S. tariffs by transporting goods through either country.

Dairy sector

Canada has made concessions to further open its dairy sector. Through the agreement, the U.S. will gain access to 3.6% of the Canadian dairy market, a slightly larger chunk than the 3.2% allocated to Pacific CPTPP countries and to Europe in the CETA trade deal. These concessions are a short-term disadvantage for Canada's dairy industry but do benefit Canadian consumers.

Trade dispute mechanisms

Canada managed to protect the trade-dispute mechanism that it holds near and dear, representing its biggest win in the negotiations. While the pre-existing anti-dumping (Chapter 19) and state-to-state (Chapter 20) mechanisms remain in place, the firm-to-state dispute resolution (Chapter 11) has largely been cut. Interestingly, the scaled back chapter was disproportionately used by U.S. firms against Canada and Mexico.

Sunset clause

Although details around the sunset clause are still blurry, it appears to be similar to what Mexico originally negotiated. This means the USMCA is subject to an official review by all parties after six years (notably, after President Trump will have left office) but is guaranteed to exist for at least 16 years. This represents a marked improvement from the original U.S. proposal for a five-year review after which the deal could be terminated immediately.

Who wins?

From a high level, all three countries win as they seemingly avoid destruction of one of the world's most successful trading arrangements and eliminate a great deal of uncertainty.

President Trump wins in that he has technically "killed NAFTA," if only in name, and proved that he can successfully negotiate a trade deal. He can now turn all of his trade aggressions towards China.

Canada wins in that it did not concede as much as originally feared. The key dispute mechanisms remain in place, the auto sector quota is well above current export levels, the sunset clause is weaker than originally envisioned and a smaller portion of the dairy sector was opened than feared.

Mexico comes off slightly less well given its auto sector will have to pay substantially higher wages in certain circumstances. That said, the country will enjoy largely unrestricted access to the U.S. market, ensuring its large trade surplus will most likely continue.

It's important to note these positives primarily stem from the agreement exceeding low expectations, rather than actually improving current trade relations. While the new deal can be perceived as slightly worse for future economic growth compared to NAFTA, the immediate risk-on response from financial markets is a reassuring response.

Overall, it's a deal North America can live with, and that's good enough.

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