Economic Analysis

New US - Mexico trade agreement significantly reduces uncertainty; not a bad deal considering the circumstances

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- **With the information available, we think it is a less favourable agreement than NAFTA itself, but better than the alternative**
- **Mexico will remain competitive in the production and export of vehicles**
- **On the positive side, the energy sector is part of the agreement; this reduces the chances of a rejection of the energy reform**
- **We are still unacquainted with the texts, so a full assessment cannot be made at this point**

What do we know so far?

On August 27, a new trade agreement in principle was announced between Mexico and the US; Canada is still in negotiations with the US to join the agreement. On August 31, the Trump administration notified the US Congress of his intention to sign a trade agreement with Mexico, which Canada could enter. As of that date, President Trump's team has a period of 30 days to provide Congress with the details of the agreement in writing, and to report on the accession of Canada, if it occurs.[1] Congress has to wait at least 90 days to approve the deal. This creates a tight deadline since it only leaves one day for President Peña Nieto to sign the deal (November 29th).

The most important amendments with regard to the North American Free Trade Agreement (NAFTA) involve new rules and clauses to be met by the automobile exports to the United States so that they are subject to a zero tariff rate. The effect on competitiveness will not be significant since even if there were no compliance with such rules, exports would face the WTO MFN tariff rate of the US in this segment, as is the case under NAFTA.

Added to the new provisions in the automotive sector, the agreement contains a definition of Sunset clause that states the agreement runs for 16 years, being reviewed every six years with a possible extension for 16 more years in each review. This new term, although not open-ended as it might been desired, enabled the unblocking of the negotiation due to the intention of the US during the entire process to include a Sunset clause, which proposed an automatic termination of the treaty after five years if the parties did not agree to extend it. The agreed conditions do not imply automatic termination after six years. In the event that at this point there is no agreement on an extension for another 16, each year they would negotiate to try to reach an agreement that would allow it to be extended for that period of time.

Chapter 19 of the previous treaty, which deals with the resolution of controversies in international panels, was not part of the agreement between Mexico and the US. However, this does not imply that this chapter has been eliminated. The issue was simply left aside to be taken up again in the negotiations with Canada which have already been resumed. Moreover, the new agreement does not cover the seasonality of agricultural exports from

1: There are doubts as to whether the Trump administration can legally submit a bilateral treaty to Congress. In the US, the Constitution gives Congress the power to negotiate international trade agreements. Usually, it is delegated by Congress to the executive via the Trade Promotion Authority (TPA). In this instance, President Trump had been delegated the authority to negotiate a trilateral agreement with Canada and Mexico, not a bilateral one.

Mexico to the US, as initially intended by the US. As far as we understand, the agricultural sector will remain open for free trade.

The agreement contemplates the openness of the Mexican energy sector, which significantly increases the costs of attempting to reverse the energy reform.

What do we partially know?

Together with the trade agreement, Mexico and the US reached an understanding regarding the signing of a parallel letter which guarantees an export quota of tariff-free units of light vehicles. This would come into force only if the US government were to impose tariffs on automotive sector imports from any part of the world for reasons of national security (232 rules). The existence of this "insurance" is undoubtedly positive given its nature. As with any other insurance, it is signed with the intention of not being used, but if needed, it would be better than the alternative. In this case, a significant share of car exports (apparently significantly above the current level) would be exempt from a possible 25% tariff that could presumably be imposed by the US. This would "shield" the Mexican sector from that tariff, increasing in relative terms that sector's competitive advantage and, therefore, investments would be made more attractive while that potential tariff remains in force. Our understanding is that the tariff-free level quota was set at 2.4 million vehicles, which is around 40% higher than current exports. Given that this level is indeed high, it could potentially increase the incentives to invest in the sector in Mexico in the short term in case the US goes ahead with the 232 rules.

Importantly, another side letter states that the same quota would apply in case the US decides for any reason to increase the current MFN WTO tariff of 2.5% for light vehicles and autoparts, and 25% for heavy vehicles, of US imports from Mexico.

What is known is positive compared to the alternatives

Overall, conditional on knowing important details, we believe that the agreement represents the best possible alternative compared, firstly, to the proposals the US had on the table throughout the negotiations on which it did not give in at any time, and secondly, to the alternative of breaking the agreement and the imposition by the US of 25% tariffs on Mexican car exports. The new agreement, as one would expect, is undoubtedly not as favourable as NAFTA but much more favourable than the alternatives. From the point of view of Mexico, the objective in this negotiation was at all times one of damage control. Based on what we know so far, it seems that the objective was fulfilled.

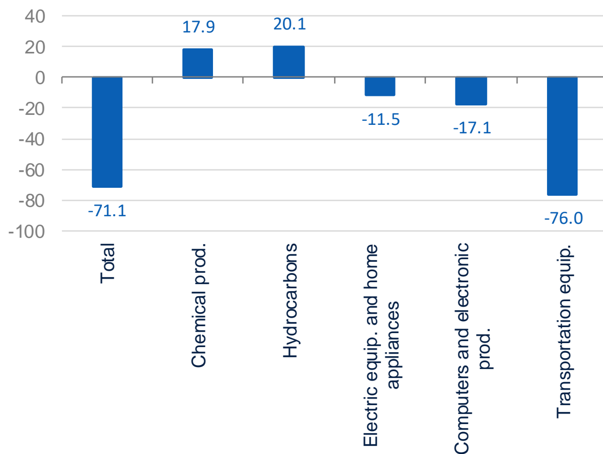
Moreover, there were some improvements in comparison with NAFTA, such as new chapters on digital commerce, anticorruption, environment and intellectual property.

The main amendments to the new agreement with respect to NAFTA are:

1. New rules for the automotive sector

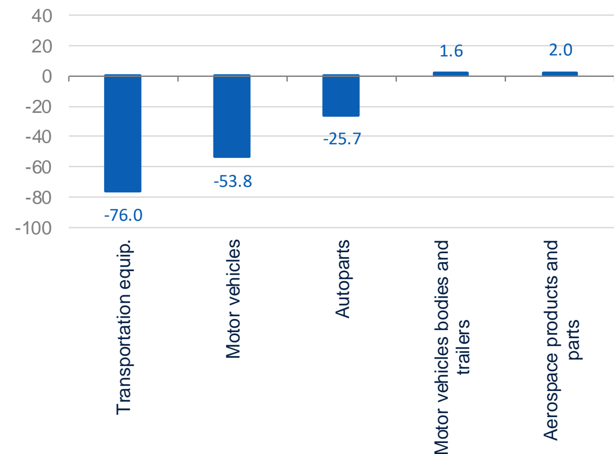
As foreseen, the most significant changes in the trade agreement were concentrated in the automotive sector, the sector behind the US trade deficit with Mexico and the primary concern of the Trump administration. In 2017, the deficit in transport equipment was US$76 billion, which is even higher than the overall US$71 billion deficit.

Figure 1. US trade deficit with Mexico in 2017
US$ billions



Source: BBVA Research / US Department of Commerce

Figure 2. US trade deficit with Mexico in transport equipment in 2017. US$ billions



Source: BBVA Research / US Department of Commerce

The new rules and clauses concerning the automotive sector incorporate the following changes:

I. **The rule of origin rises from 62.5% to 75% for regional content in motor vehicles.** The increase in regional content is not a bad deal compared to the 85% level initially proposed by the US, and discards the minimum 50% threshold of US content proposed in the early stages of negotiation. Considering that the MFN WTO tarrif will remain in place, these more strict rules will not affect competitiveness even if the new thresholds are not met.

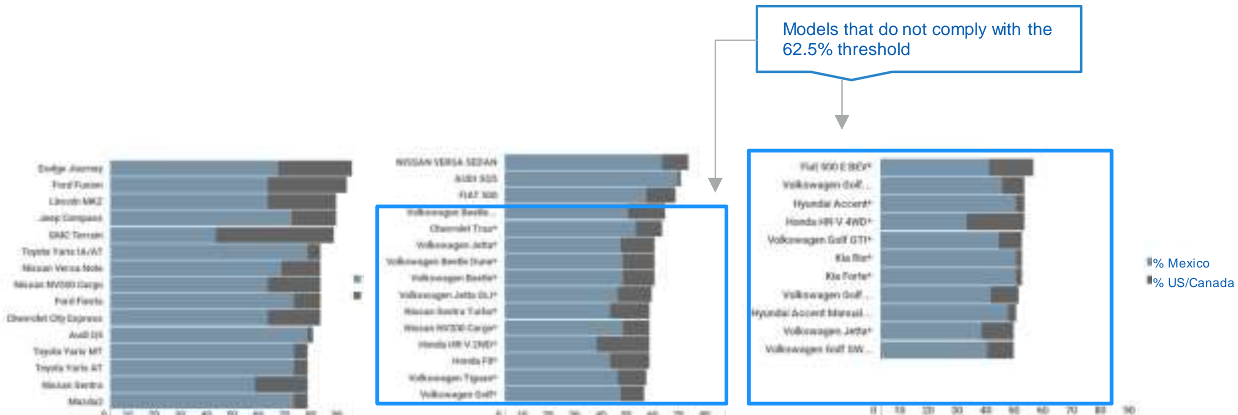
II. **70% percent of steel and aluminium must come from North America.**

III. **Between 40% and 45% of the content of a motor vehicle must be produced in regions with a salary of at least $US16 per hour.** Currently, the average wage in Mexican automotive sector is $US8 per hour. As of now, half the models assembled in the country would not meet the threshold.[2] Such measure imposes operating and administrative costs on companies by requiring them to identify and check the average salary of the regions where the added value of the vehicle comes from. As with the regional content requirement, this one should not be binding because exports will continue to face the 2.5% MFN tariff.

We believe that the amendment regarding regional content is not a factor which reduces industry competitiveness by itself. The non-compliance with the current rule of origin of 62.5% has not been a limiting factor, since light vehicles can be exported to the US at the 2.5% Most Favoured Nation (MFN) tariff, which the US has registered with the WTO. In fact, at present, several models are already being exported with this tariff, which has not diminished the competitiveness of auto manufacturing in Mexico (Figure 3).Besides, the real exchange rate depreciation over the last four years more than offsets this low tariff. However, the 2.5% tariff is not applicable to freight transport (6.1% of total exports) which will continue to face a 25% tariff for those units not complying with any of the three requirements described above. Thus, the competitiveness of the automotive sector will not be materially affected under the new agreement, Currently, approximately 697 thousand units (35% of light vehicle exports) would not comply with the 75% rule of origin.

2: Also see Nafta 2.0: what's on the table? by Capital Economics

Figure 3. Exports of light vehicles from Mexico to the US. Units



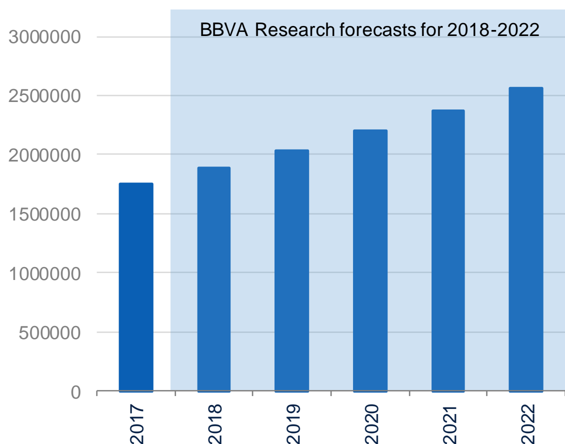
Source: BBVA Research with news sources. The models with (*) correspond to those on which the tariff was already being paid

2. Side agreements: the ceiling regarding units of light vehicles exported from Mexico to the US constitutes "insurance" which sends a positive signal

In addition to changing the regional content thresholds and establishing a minimum percentage of production in high-wage regions, the governments of the US and Mexico agreed, as explained by the Ministry of Economy, in parallel on the signing of a letter guaranteeing the free export of a certain number of 2.4 million light vehicles per year should the Trump administration decide to impose new tariffs on the automotive sector for reasons of national security (rules 232), or if it opts to increase the current MFN tariff for Mexican imports.

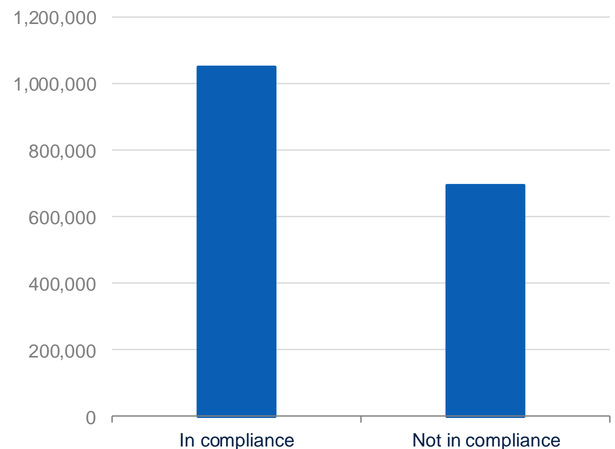
Our assessment of this measure is positive as it represents an insurance policy against a possible increase in tariffs due to national security concerns or other reasons like the US withdrawal from the WTO. At the current rate, the quota of 2.4 million light vehicle exports would be reached in 2022 (Figure 4). In the short term, producing and investing more in Mexico would even be encouraged given the alternative of facing a tariff 10 times lower of what would be paid by exporting from elsewhere (ie, a possible tariff of 25%). Besides, it is hard to imagine that such a large tariff (25%) on such an important sector would prevail for several years, as it would most likely translate into a fully blown trade war.

Figure 4. Exports of light vehicles from Mexico to the US. Units



Source: BBVA Research / INEGI

Figure 5. Exports of light vehicles from Mexico to the US. that would comply with 75% regional content in 2017. Units



Source: BBVA Research / INEGI

3. With the new agreement in force for 16 years and the non-seasonality of agricultural imports, the most toxic proposals have been eliminated

Among the most problematic proposals during the negotiation process was the automatic expiration clause every five years (unless the countries party to the agreement decided to renew it), which was discarded. It was agreed, instead, that the new agreement will be in force for 16 years with reviews every six years, making it possible to extend it for 16 more years at each revision. Thus, while it is worse than the alternative of an indefinite period, it is positive since private investment will benefit from better medium- and long-term planning. The 16-year duration of the new agreement will help private investment, both domestic and foreign, to eventually recover its momentum and contribute more to economic growth in the coming years. In addition, the seasonality which the US wanted to impose on agricultural imports was not included in the new agreement.

Domestic financial assets have not benefited from the announcement of the agreement as uncertainty remains due to both Canada's absence from it and the lack of details

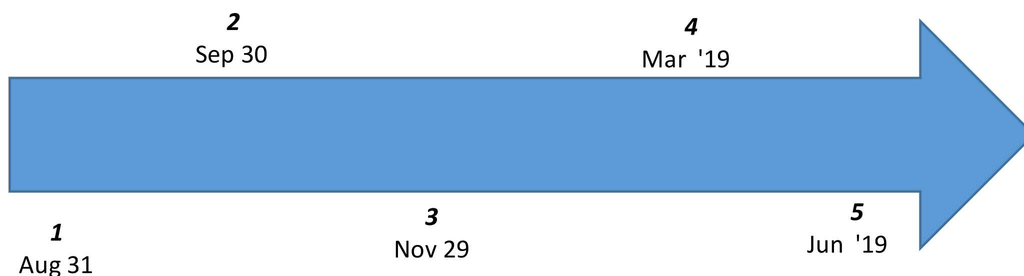
The announcement of the preliminary agreement has not had an effect on domestic assets. MXN, CDS and long-term rates have not reacted to it as would have been expected. We believe that the limited effect of this event on the foreign exchange market was mainly due to three factors. First, in the anticipation of a possible agreement, financial assets were already partially pricing in this outcome. Second, the details of the agreement are not publicly known since the texts of the latter are unavailable (they need to be ready by September 30th at the latest). Third,, the fact that Canada is not at this point part of the agreement, lessens the chances that it will be approved swiftly.

The announcement of a preliminary trade agreement with the United States reduces the likelihood of tail events or extreme scenarios regarding financial variables over the short term. Since the resolution on the NAFTA renegotiation was the main idiosyncratic risk to the Mexican economy, the announcement of the agreement should eventually benefit domestic financial variables. Additionally, it is encouraging that Mexico already has an agreement with the US on the current environment regarding the possible unilateral imposition of tariff rates.

The approval process in the US

In accordance with US legislation, after notification of the agreement (August 31), the deal cannot be approved in less than 90 days. This leaves only one day (November 29th) to President Peña Nieto to sign the deal. This is the reason why the Trump administration rushed the notification to Congress even without reaching an agreement with Canada. As we have mentioned, the final texts should be ready by September 30th. Once signed by the executive power, the ratification period begins in Congress. The first step is an analysis of the economic impact of the agreement by government economists, for which a period of 105 days is expected, which would end around the first half of March. Once this analysis has been carried out, Congress has 90 days to ratify the agreement. Therefore, it will be difficult for the recently announced preliminary agreement to pass through all the legal stages in order to enter into force before the second quarter of next year. Moreover, it seems very difficult that the current US Congress with Republican majority will have time to ratify the agreement.

Figure 6. The agreement's approval time line in the US.



1	Notification to Congress
2	Release of the full text of the agreement
3	Signature of the agreement
4	Deadline for economic impact assesment from government economists
5	Deadline to ratify the agreement

Source: BBVA Research / Bloomberg

Bottom line

The reaching of a preliminary agreement is undoubtedly positive and the information we have so far points to the fact that the Mexican economy will not be affected in structural terms as was feared before. The deal will not affect the automotive sector's competitiveness and it could even been increased in the short term with the side agreements if the US ends up imposing 25% tariffs on imports of automotive products. The 16-year duration of the new agreement is not ideal but much better than the initial proposal, and there would be plenty of time to possibly fix this along the way. The fact that the Mexican energy sector reduces the chances of seeing a reversal of the reform.

In a nutshell, this agreement is not as good as the original one, but is better than the alternative and it will not disrupt value chains, investment and trade between Mexico and the US.

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