Economic Analysis

USMCA: uncertainty reduced, but not removed

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We now know the content of the new North American free trade agreement, to be known as the United States-Mexico-Canada Agreement, or USMCA. The three countries' negotiating teams announced details on Sunday, just minutes before the deadline for the Trump administration to submit it to Congress. The fact that Canada has joined the agreement is very positive, above all because it improves the chances of its being approved by the US Congress.

Having carried out an initial review of the text, I think the original assessment made in a previous article still stands – namely, that it is a good agreement given the circumstances, and above all much better than the alternative. It is an agreement that should not prove disruptive as far as trade, investment and value chains are concerned.

Perhaps the most significant changes are those affecting the automotive sector. This is not surprising, given that the sector accounts for the entire trade deficit that the United States runs with Mexico. The Trump administration demanded a number of restrictions, on the basis that these would lead to a greater proportion of North American automotive production taking place in the United States, yet failing to realise that these restrictions would not in fact result in increased levels of production in the US but in a decline (albeit not a very significant one in my view) in the region's competitiveness.

The new agreement stipulates that in order for a vehicle to qualify for zero US import duty it must meet three requirements: i) 75% of its value has to originate from one of the three USMCA countries, ii) 70% of the steel and aluminium it contains should come from North America and iii) 40% of its value (45% in the case of trucks and vans) must be produced by workers earning at least 16 dollars an hour. It is possible that approximately half of the models produced in Mexico will fail to meet one or more of these requirements.

However, this should not prove restrictive. At present, about one third of the vehicles that Mexico exports to the United States do not meet the requirements of the 1994 agreement and therefore do not qualify for the zero tariff. However, they can still be exported, paying an import duty of 2.5%, which is the World Trade Organisation (WTO) Most Favoured Nation (MFN) rate applied in this case. This import duty does not make vehicle manufacturing in Mexico uncompetitive.

However, we need to look at two possible changes to the above. Firstly, the new agreement stipulates that if the US decides to impose higher import duties on automotive imports from the rest of the world for reasons of national security, Mexico and Canada will each be exempt as regards the first 2.6 million units in any given year. Mexico currently exports 1.7 million units a year to the US. At the current rate of growth, it will take about five years to reach the higher level. I find it difficult to imagine that the US would be able to maintain high tariffs on imports from the rest of the world for such a long time. There is another aspect of the agreement that poses a risk, namely that if the US increases its 2.5% MFN tariff (which to do so would either mean having to go through a complex process or leaving the WTO entirely), the US will maintain the 2.5% rate for Mexico. However – and this is where the risk lies – it stipulates that in this case an annual quota of 1.6 million units may be imposed, above which the new tariff would apply. This quota, unlike the 2.6 million, would be restrictive, since it is below the current level of annual exports to the US.

In summary, should it come into effect, the new agreement will substantially reduce the risks to the automotive sector, but there remains the question of the US managing to raise its MFN tariff and also deciding to apply the quota referred to. I believe this is a low-probability risk, but one which, if it were to materialise, would have a serious negative impact.

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