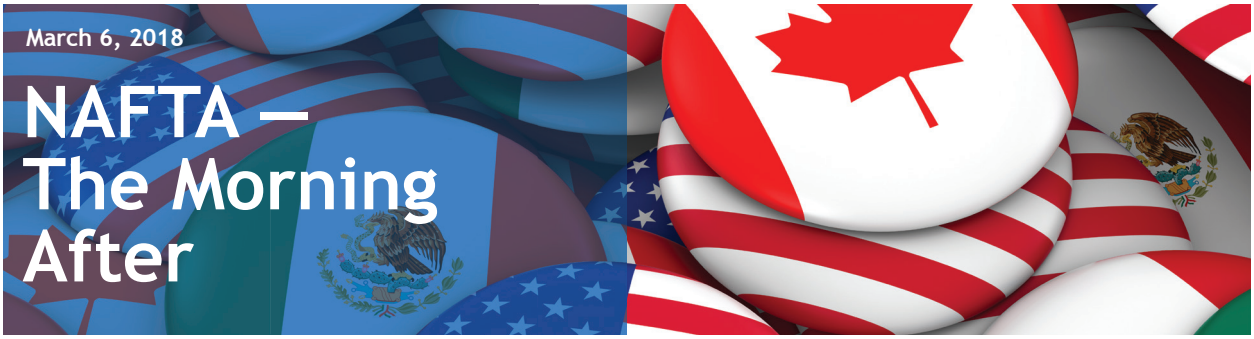
ADDENDA CAPITAL



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NAFTA — The Morning After

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The renegotiation of the North American Free-Trade Agreement (NAFTA) is down into the last stretch but, a few weeks away from a possible outcome, the end result of the process remains a question mark.

One should also be reminded that it was President Trump who forced Canada and Mexico to renegotiate NAFTA, in force since January 1, 1994, which he called "the worst trade deal maybe ever signed anywhere". Now, after seven rounds of negotiations, the mood remains rather gloomy. The Chief negotiators on all sides[1] continue to say that they hope to reach a new agreement while continuing to damp down expectations. Many of the least contentious issues have been settled but, with regards to U.S. priority demands, most of which are highly protectionist, the negotiating position of U.S. Trade Representative Robert Lighthizer has not moved one bit.

It would be tempting to conclude that in a negotiation of this importance for all three partners, led by experts in a context of good faith, common interest should ultimately triumph. In game theory, the solution to this kind of balance of power is referred to as a Nash equilibrium[2], in which each player correctly forecasts the behaviour (choices) of the others and maximizes his own advantage considering this forecast. Per this equilibrium, no player regrets his choice (it was the best he could make) in view of the choices of the others, the choices all being simultaneous.

Unfortunately, the current framework for renegotiating NAFTA does not include the necessary and sufficient conditions for reaching a Nash equilibrium. In fact, the current balance of power between the parties rather resembles a three-body problem[3] in a chaotic system[4] in which a small difference in initial conditions can have a disproportionate effect on the outcome. In our case, the small difference in initial conditions comes from President Trump's erratic behavior since he heads the biggest economy. He could single-handedly derail the process.

Important Considerations

President Trump can, on his own initiative, decide to issue a notice of the United States' intent to withdraw from NAFTA. However, Congress could refuse to legislate to give force of law to this withdrawal[5]. In fact, according to the Constitution, it is Congress that has the power "to regulate commerce with foreign nations". In practice, Congress periodically delegates this power to the administration through the Trade Promotion Authority (TPA) mechanism. This delegation of power mandates the administration to negotiate commercial agreements that must ultimately be ratified by Congress[6].

The current delegation of power in effect since 2015 could expire on July 1, 2018, if Congress adopted a motion to oppose extending it to 2021. Given Republican control of both chambers, it is unlikely that such a motion of opposition would be adopted, but it is not impossible if enough Republicans in favour of free trade want to oppose the President's threat to take the United States out of NAFTA. The renewal clause already enshrined in the current TPA requires the President to request a renewal of the TPA before April 1, 2018, as well as report on the state of negotiations for agreements currently under review and the reasons justifying further negotiations. Moreover, some statutes enacted by Congress enunciate circumstances where the President may adjust tariffs and duties to promote or protect U.S. interests. These actions may be challenged in court, notably the U.S. Court of International Trade (CIT)[7].

The seventh round of negotiations concluded on March 5 in Mexico City in the middle of controversy[8] and the eighth round is to be held in Washington around the end of March. The stumbling block for negotiations continues to be four issues on which the United States is unyielding (see page 2).

- **Chapter 19: Review and Dispute Settlement**
  - The United States wants to eliminate the panel of experts currently delegated under NAFTA so that henceforth disputes would be argued before American courts.
- **Auto manufacturing:** The United States is demanding minimums of 85% of North-American content and 50% of American content to avoid tariffs (versus current levels of 65% and 0%, respectively)[9].
  - The aim is to make imports of vehicles and components from Asia less competitive and to repatriate more manufacturing to the United States.
- **Sunset clause:** The United States wants the new agreement to expire after every five-year period, unless all three countries agree to renew it.
  - This would leave NAFTA in a state of constant uncertainty and would attract foreign investment to the United States rather than to Mexico or Canada.
- **Poultry and dairy products:** The United States wants Canada to eliminate the trade barriers to exports to Canada imposed by supply management.

Many analysts believe that of the four U.S. demands, the one to eliminate chapter 19 (panel of experts to examine and settle disputes) is likely to constitute the main stumbling block on which the U.S. position will remain inflexible.

Be that as it may, if the next round of negotiations in Washington were to free things up, there could be an agreement in principle before May 1, after which it would become difficult to continue negotiations with the proximity of the Mexican elections (July 1) and the U.S. midterm elections (November 6).

If there is insufficient progress toward reaching an agreement, it is possible that the parties will agree to postpone negotiations until 2019. In this case, the dynamic could change. In Mexico, there is a chance that power could fall into the hands of the left-wing Andrés Manuel López Obrador and that, in the United States, the Democrats could regain control of one of the chambers. Even if negotiations remain deadlocked after the Washington round, it seems probable that the President may still ask Congress to extend the TPA, giving the impression of at least wanting to continue to negotiate in good faith. After the July 1st deadline for Congress to oppose extending the TPA, it would not be surprising if President Trump sent the notice of the U.S. withdrawal from NAFTA. This way the author of "The Art of the Deal" would throw a wrench into the works and please his electoral base in the run-up to the mid-term elections.

Given that all three scenarios are plausible, we have to anticipate the possible consequences of each one on our investment strategy. If an agreement was reached soon (1) or if negotiations were postponed to 2019 (2), the likelihood of our base case scenario of strong growth and moderate inflation would increase. The conclusion of an agreement would engender a wave of optimism particularly favourable to Canadian and Mexican equity markets. The postponement of negotiations to 2019 would have little immediate impact.

If President Trump issues the notice of withdrawal (3), the impact on the economies of the three partners could take some time to unfold. However, the outlook for investment in Canada and Mexico would darken and household confidence would be shaken. Financial markets would react quickly to such an announcement. The Canadian dollar and the Mexican peso would take a hit, as would the Canadian and Mexican stock exchanges. It is highly likely that the Bank of Canada would apprehend a weaker economic outlook, which could prompt it, at least temporarily, to delay further raising the policy rate or even return to an easing policy. In Canada, risk aversion would return, pushing bond yields lower along the yield curve but more so in the short maturities. Credit spreads would increase, especially for the securities of companies most exposed to global trade.

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[1] Robert Lighthizer for the United States, Steve Verheul for Canada and Kenneth Smith Ramos for Mexico.

[2] We owe this concept to the American mathematician, John Forbes Nash, Nobel Prize laureate in economics. This is a solution to a non-cooperative game (e.g. a negotiation) between parties in which each party knows the other parties' optimization strategy, and no party has anything to gain from changing its own strategy when the other parties don't change theirs.

[3] Problem for which the French mathematician Henri Poincaré demonstrated in 1887 that there is no general closed-form solution.

[4] System described by the mathematician and meteorologist Edward Lorenz.

[5] Senator Orrin Hatch (R), President pro tempore of the United States Senate said that Congress would override any move by President Donald Trump to pull the United States out of NAFTA.

[6] NAFTA has force of law under a Congressional Executive Agreement concluded between the Clinton administration and Congress (January 1, 1994). To terminate it, Congress would have to legislate to end existing legislation.

[7] A recent example is the countervailing duties imposed on the sale of Bombardier's C-Series jets to Delta Airlines that the U.S. International Trade Commission invalidated even before it could be brought in front of the CIT.

[8] During the round, President Trump announced import tariffs of 25% on steel and of 10% on aluminum and that neither Canada nor Mexico would be exempted unless a new NAFTA was concluded.

[9] Early into the Mexico round, the United States recalled its Head negotiator of the regional auto content rules, Jason Bernstein, to Washington for meetings with U.S. automakers and Robert Lighthizer, the Chief U.S. negotiator. It is unclear whether this was a sign of movement in the U.S. negotiating position or another stalling tactic by the United States.