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Whither NAFTA? (Part II)

Jorge Miranda (Cassidy Levy Kent LLP) · Wednesday, December 20th, 2017

This a second post in a series of posts commenting on the NAFTA renegotiation process. For Part I click here.

What is Mexico's Real "Plan B"?

- The Mexican press is full of statements to the effect that, should the United States withdraw from the NAFTA, Mexico would compensate any substantial reduction in exports to the U.S. market by sharply ramping up its exports to third markets. This is nothing more than a fantasy because third markets often do not have the required complementarities with the Mexican economy (that is to say, they produce labor-intensive goods too) nor are they sufficiently large to substitute for the U.S. market. Besides, third markets can be geographically distant (putting Mexican exporters at a considerable disadvantage in terms of freight costs) and, more importantly, generally have levels of tariff protection that are significantly higher than the U.S. most-favored nation ("MFN") tariff that would be applicable to Mexican exports if the United States were to withdraw from the NAFTA. China is a case in point. So is India. China's and India's average MFN applied tariffs are 9.9 and 13.4%, respectively, which compare unfavorably with the U.S. average MFN applied tariff of 3.5%. In addition, 48.4% of the U.S. tariff lines corresponding to non-agricultural products have a MFN rate of zero. The comparable proportion for China and India is only 6.9 and 2.5%, respectively.[1] Thus, Mexico's real "Plan B" can be no other than continuing exporting to the United States but under the MFN rates instead of the NAFTA rates.
- That Mexico, with the United States outside of NAFTA, can continue exporting to this market under the very low *average* MFN rate does not mean that its export volumes would not be affected to some extent by a U.S. withdrawal. This is so because the *average* MFN rate of the United States masks tariff *peaks* for specific products that can be much higher.[2] By way of illustration, the U.S. MFN rate for imports of textiles and clothing can be as high as 34 and 32%, respectively.[3] Thus, the actual adverse impact that Mexico would suffer if the United States withdraws from the NAFTA would be contingent upon the proportion of Mexican exports to the United States that would become subject to tariff peaks.

How Might The United States Fare In Case Of A Withdrawal?

- The short but truthful answer to this question is, probably worse than Mexico. For starters, this would be so because Mexico's average applied rate (which would kick in the event of the United States withdrawing from the NAFTA) is 7% which is twice as high as the U.S. average MFN rate of 3.5%.[4]

- Crucially, outside of NAFTA, U.S. exporters will not only be subject to Mexican import duties that on average will be significantly higher than average U.S. import duties but they would also likely be undercut and displaced from the Mexican market by suppliers from the other 45 countries covered by the 12 free trade agreements that Mexico is a party to, including Canada remaining in the NAFTA.[5] This prospect is particularly threatening for U.S agricultural producers with huge exports to Mexico and for whom Canada is a key competitor (for instance, U.S. grain and meat producers). Mexican exporters would not be exposed to nearly the same risk because the United States has signed fewer free trade agreements.
- If, following a U.S. withdrawal from the NAFTA, U.S. exports to Mexico contract by a larger proportion than Mexican exports to the United States, the U.S. trade deficit with Mexico might end up increasing.
- The U.S. trade deficit with Mexico might also end up increasing if the U.S. withdrawal from the NAFTA triggers further depreciation of the Mexican peso through capital flight, because such depreciation could nullify or even overcompensate the increase in the U.S. import duties faced by Mexico implied in the switch to MFN levels.

If a U.S. withdrawal from the NAFTA would be costly for both the United States and Mexico but could be costlier for the United States than for Mexico, there is a question as to whether, alternatively, mechanisms could be found, within the framework of the NAFTA and WTO rules, that could further boost U.S. exports because, at the end of the day, that really has to be the core objective from the perspective of the United States. I discuss this issue in my next post.

[1] See https://www.wto.org/english/res_e/booksp_e/tariff_profiles17_e.pdf. Profiles for China, India and the United States.

[2] In practice, the tariff schedules of all WTO Members have tariff peaks that can be substantially higher than the average.

[3] See https://www.wto.org/english/res_e/booksp_e/tariff_profiles17_e.pdf. Profile for the United States.

[4] It should be born in mind that, purely on account of domestic policy considerations, Mexico applies import duties that are substantially lower than those bound at the WTO. In particular, Mexico's average bound rate is 36.2% which is over five times higher than its average applied rate of 7.%. See https://www.wto.org/english/res_e/booksp_e/tariff_profiles17_e.pdf. Profile for Mexico.

[5] For a list of the free trade agreements entered into by Mexico, see World Trade Organization, *Trade Policy Review – Mexico, Report by the Secretariat*, WT/TPR/S/352, circulated on 15 February 2017, at page 37, Table 2.2.

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*The opinions presented in this Post are mine alone and do not represent in any way official views of King & Spalding LLP or its clients.

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