Economic Analysis

US-Mexico trade agreement: the best one that was possible under the current circumstances

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The presidents of Mexico and the US have announced a preliminary bilateral commercial agreement. If congresses in each country approve it, this accord will replace the North American Free Trade Agreement (NAFTA) that has been in place since 1994.

According to the trade delegations from the two countries and the declarations of those involved in the negotiations, the central points of the agreement are as follows:

1) Rules of origin applicable to the automotive sector. The regional content will go from 62.5% under NAFTA rules to 75% with the new bilateral agreement (lower than the original 85% sought by the US). This means that three quarters of the parts that make up a car will have to be manufactured in the US or Mexico in order for them to have tariff-free access to their markets. According to the Mexican Minister of Economy, 70% of cars exported already meet the new criteria, with a four-to five-year grace period for those that do not comply with the regulation. While the increase in the regional content requirement is important, the proposal for an exclusively 50% US content that the Trump administration had suggested in October 2017 has been ruled out. This was a clearly protectionist measure without precedent in any trade agreement anywhere in the world.

2) Wage clause. A new rule will require between 40% to 45% of auto parts to be manufactured in countries in which the workforce are paid at least $16 per hour. This new measure will only affect Mexico, where workers in the automotive sector earn an average of $8 per hour compared to $29 per hour in the US and Canada.[1]

3) Sunset clause. The American proposal of automatically breaking the trade agreement in the event that either party does not confirm their adherence after a five-year review period was taken off the table. Instead, the bilateral accord will be valid for 16 years, with reviews every six years from 2024 onward. Such proposal was one of the main sticking points for the uncertainty that this would mean for investment. Mexico and Canada were strongly opposed to the sunset clause.

4) Seasonality clause. The US proposal that Mexico should only be able to sell certain agricultural products at specific times of the year was taken off the table. Agricultural trade will continue to be free from tariffs and subsidies.

5) Resolution of disputes. Mexico agreed to end application of the NAFTA's dispute settlement mechanism (Chapter 19). This chapter establishes that trade differences between private companies shall be resolved by independent panels. As this mechanism is no longer available, any trade dispute will be resolved by American courts. Negotiators have said that under the new agreement, certain sectors, including energy, will use *ad hoc* dispute resolution mechanisms.

1: According to the Center for Automotive Research, the average wage for assembly plant workers in Mexico is under $8 per hour.

Assessment

In general, we consider that the trade agreement between Mexico and the United States announced today is positive for both economies, especially in the case of Mexico. For the latter was essential to close the negotiation with its main trading partner- the destination for 80% of its exports and from which it receives 50% of foreign direct investment.

This is not a perfect agreement, but given the circumstances, it seems like the best one that was possible. We take the view that a probable alternative scenario could see the imposition of a 25% levy on Mexican car imports or the cancellation of NAFTA.

As for the agreements reached within the automotive sector, in our view they are positive for the following reasons: (i) higher regional content requirement might imply more Mexican value-added to such sector; (ii) many companies will continue to be competitive despite a wage increase to $16 per hour levels in the auto parts sector, which would result in an improved situation for Mexican employees; and (iii) in the case of light vehicles and auto parts, those companies that do not meet the rules of origin will be able to export to the US paying a tariff of 2.5%. Bearing in mind the peso's real depreciation, the sector would be more competitive than it was a few years ago even when considering this tariff. However, in the case of light trucks, there might be a significant impact since these vehicles will have to pay a 25% tariff should they not comply with the rules of origin.

As far as the dispute resolution is concerned, the cancellation of the NAFTA's dispute resolution mechanism represents a significant risk for the Mexican economy, given the lack of an impartial body that resolves disputes between private companies and the American government.

The fact that the energy sector is included in the agreement is positive since it supports the energy reform and this will imply, as we have mentioned on other occasions, a boost to both investment and job creation.

If Canada is not part of the agreement, it is worth mentioning that Mexico and Canada will have a modern trade agreement within the TPP framework. However, the US-Mexico trade agreement will have a greater impact and be more beneficial to Mexico, the US and Canada, if the latter signs up.

It is also positive that the agricultural sector will remain open. This minimises the possibility that one of these two countries imposes subsidies to the sector, which would result in efficiency distortions and losses.

Market reaction

The Mexican peso registered a slight appreciation of 0.78% at the close of the business day, representing a marginal positive differentiation with regard to currencies from emerging countries. In the government debt market, the yield curve fell off slightly by 3bp while the 5-year CDS spread was only down by 2bp. This highlights the fact that the market has partially incorporated an agreement and is awaiting further details. Looking forward, we consider that domestic assets would be less affected in relation to other emerging assets when faced with greater global risk aversion.

Conclusion

Bearing in mind that this is a preliminary agreement, the announcement of the trade accord is favourable for Mexico, especially when we consider the alternative outcome. Furthermore, in a context in which most world economies face great uncertainty in terms of their trade relationship with the US, it is positive that the source of this uncertainty is no longer there. We will have to wait for the approval of the congresses from the two signatories countries to be able to quantify the medium- and long-term benefits with more certainty.

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