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QUEST Trade Policy Update

Ernst & Young LLP's Quantitative Economics and Statistics (QUEST) group's Trade Policy Brief summarizes the latest key events and potential trends on international trade and its domestic and global implications in a relatively concise, easy-to-read format.

QUEST Trade Policy Brief:

Unsuccessful NAFTA renegotiations could adversely affect economic growth and cause potential trade war with Mexico

Unsuccessful North American Free Trade Agreement (NAFTA) renegotiations could adversely affect US economic growth and jobs as high tariffs could cause US companies to outsource production abroad and could result in higher prices for imports. Contrary to simple intuition, expansion of US firms into Mexico plausibly increases rather than decreases economic activity, including jobs, in the United States. Because 40% of the value of imports from Mexico actually is created in the United States, imposing tariffs on such imports directly taxes US production.

From free trade to a looming trade war

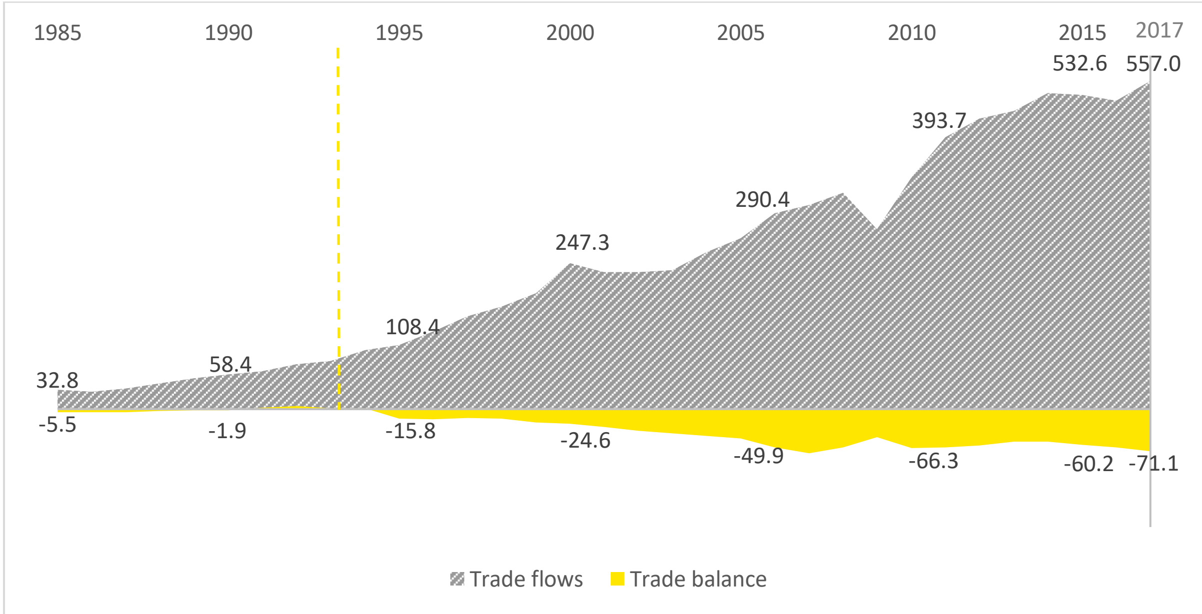
Since joining NAFTA, Mexico has become a primary US trading partner and a sizable investor in the US economy, with aggregate merchandise trade exceeding $500 billion in 2017. Both countries benefit from special duty status, granting them tariff exemptions from the Harmonized Tariff Schedule (HTS), which reduces the total cost of trade for their domestic corporations. This arrangement has enabled the development of highly integrated production-sharing systems across the two economies where manufacturers in both countries work together to efficiently produce goods.

President Trump believes that NAFTA is unfair to the United States and threatened to withdraw from NAFTA throughout his presidential campaign. On January 23, 2017, he signed an executive order to renegotiate the agreement. Since then, economic tensions between the United States and Mexico have increased as negotiation teams have been unable to reach a fully revised agreement acceptable to both parties.

Negotiators have also faced challenges outside of trying to modify the terms of the agreement itself. On March 23, 2018, the US imposed stiff duties on steel and aluminum articles at 25% and 10% respectively. Canada and Mexico are among the top traders with the United States in these goods; thus, the ultimate outcome has impacted negotiations. Initially, Mexico was included in temporary country exemptions from the tariff, but as of June 1, 2018, that exemption has been suspended and was swiftly met with retaliatory duties by Mexico on key US exports. Additionally, President Trump has threatened high tariffs (perhaps 25%) on auto imports, including those from Mexico, presumably motivated in part as a way to secure what he sees as more favorable terms in the NAFTA negotiations.

Mexico has become a primary US partner for merchandise trade and a sizable investor in the US economy

Figure 1. US merchandise trade with Mexico ($ billion)

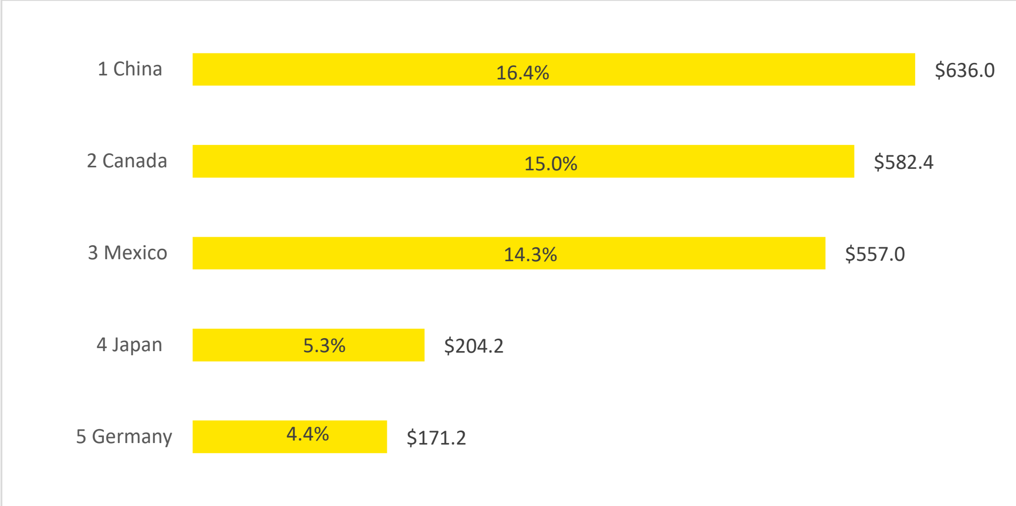


Source: US Census Bureau. Dashed line represents NAFTA enactment in 1994.

Between 1985 and 2017, trade flows between the United States and Mexico increased from $32.8 billion to $557.0 billion and most of this occurred after the enactment of NAFTA in 1994 (Figure 1). As aggregate trade has increased for both countries, the US trade deficit with Mexico increased from $1.9 billion in 1990 to $71.0 billion in 2017, reflecting both the higher dependence of the US economy on imports from Mexico and the increasing interconnectedness of the two economies due to integrated production sharing systems.

In 2017, Mexico ranked third (after China and Canada) as a source of merchandise trade with the US and accounted for 14.3% of overall US merchandise trade or $557.0 billion (Figure 2). Mexico was the second largest destination of US exports (after Canada) and the second leading supplier of imports (after China).

Figure 2. Top five US partners in aggregate merchandise trade in 2017 ($ billion)



Source: US Census Bureau.

Mexico is an important trading partner with many individual US states. Mexico accounts for more than 25% of total exports from Texas, New Mexico, and Arizona and is the second most important export market for 17 states.[1] Mexico also is among the top three sources of imports for more than a dozen states. Not surprisingly, America's trade with Mexico has been an important source of employment nationally, generating up to 6 million (or 4%) US jobs.[2]

[1] Wilson, Christopher E. November 2011. *Working Together. Economic Ties between the United States and Mexico.* Mexico Institute, Woodrow Wilson International Center for Scholars.
[2] Ibid.

In addition to increasing merchandise trade flows between the United States and Mexico, NAFTA has influenced investment patterns between the two economies. Since the enactment of NAFTA, the stock of US foreign direct investment (FDI) in Mexico has risen from $17.0 billion in 1994 to $87.6 billion in 2016 while reciprocal Mexican FDI in the United States has increased from $2.1 billion in 1994 to $16.8 billion in 2016.[3]

Perhaps counterintuitively, research suggests that job growth at affiliates of US multinational corporations (MNC) operating in Mexico often creates jobs and other benefits in the United States. For example, a 10% increase in employment at foreign affiliates in Mexico on average leads to: (1) a 1.3% increase in employment per MNC in the United States; (2) a 1% increase in US sales; (3) a 1.7% increase in exports from the United States; and (4) a 4.1% increase in research and development spending in the United States.[4] This research casts doubt on the commonly encountered assertions about the effects of "exporting jobs overseas."

Top US exports to Mexico

US merchandise exports to Mexico totaled $243.0 billion (15.7% as a share of total US exports) in 2017, which were primarily composed of machinery and fuel (Table 1).

Table 1. Top five US merchandise exports to Mexico in 2017

Rank	Products	$ Billion
1	Electrical machinery	29.4
2	Petroleum and petroleum products	21.3
3	Motor vehicles	21.0
4	Office machines and equipment	15.9
5	General industrial machinery	13.7

Source: US Census Bureau.

Top US imports from Mexico

US imports from Mexico totaled $314.0 billion (13.4% of total US imports). The top five US imports from Mexico by decreasing order of importance in 2017 were motor vehicles, electrical machinery, communications equipment, office machines and equipment, and general industrial machinery (Table 2).

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[3] Villarreal, Angeles M. March 27, 2018. *U.S.-Mexico Economic Relations: Trends, Issues, and Implications. Report No. RL32934.* Congressional Research Service.

[4] Moran, Theodore H. and Lindsay Oldenski. November 2014. "How U.S. Investments in Mexico Have Increased Investment and Jobs at Home" in *NAFTA 20 Years Later*, Washington, DC: Peterson Institute for International Economics.

Table 2. Top five US imports from Mexico in 2017

Rank	Products	$ Billion
1	Motor vehicles	83.5
2	Electrical machinery	36.8
3	Communications equipment	25.6
4	Office machines and equipment	20.9
5	General industrial machinery	17.3

Source: U.S. Census Bureau.

US and Mexican economies depend highly on each other due to NAFTA, geographical proximity and global supply chains

Tables 1 and 2 show overlap between some top US exports and imports with Mexico. This is particularly true for motor vehicles, ranked third as US exports to Mexico and first as US imports from Mexico. This situation is emblematic of the highly integrated US-Mexico supply chains in the auto industry. As an illustration, one study reported that auto parts cross United States borders as many as eight times between Canada, Mexico and the United States due to highly specialized and technologically driven fabrication processes.[5] A recent Wall Street Journal article indicated that components from four different US states and four Mexican locations are incorporated into seats produced for automobiles in the Midwest.[6]

Since 2008, Mexico's production of light vehicles has surpassed Canada's and now accounts for 20% of total North American production, making it the second largest producer in the region behind the United States. This significant growth of the automobile manufacturing sector in Mexico is partially driven by: (1) US demand, which captures 83% of Mexican heavy truck production; (2) the favorable trade environment between the two countries, which has encouraged inward and outward trade and investment flows; and (3) the complex production sharing arrangements, which emerged in both countries. Mexico is the largest export market for US auto parts (more than $20 billion in 2017). It has become the seventh largest vehicle producer in the world and first in Latin America with a total vehicle production exceeding 3 million units.[7]

Mexico is by far the trading partner whose economy is the most integrated with the United States. Table 3 shows that about 40% of the value of US imports from Mexico consist of US value-added content returning home after processing in Mexico, and 42% of the value of US exports to Mexico

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[5] Wilson.
[6] Althaus, Dudley and Christina Rogers. November 10, 2016. "Donald Trump's NAFTA Plan Would Confront Globalized Auto Industry." *Wall Street Journal*.
[7] Center for Automotive Research. July 2016. *The Growing Role of Mexico in the North American Automotive Industry. Trends, Drivers and Forecasts.*

consist of Mexican value-added content processed in the United States.[8] Not surprisingly, there is a growing body of research suggesting that both economies' business cycles have become more synchronized in the past two decades due to production sharing in the manufacturing sector. Therefore, a growth in Mexican exports, which is good for the Mexican economy and generates Mexican jobs, may also directly benefit the US economy and generate American jobs through vertical specialization, and vice versa.

Table 3. Tracing value added in global supply chains

Partner country	US value-added content in imports from partner country (%)	Partner's value-added content in imports from the US (%)
Mexico	39.8	42.2
Canada	24.7	32.4
China	4.2	7.0
Brazil	2.8	0.3
EU	2.1	4.4

Source: Koopman, Robert, William Powers, Zhi Wang, and Shang-Jin Wei. September 2010.*Give Credit Where Credit is Due: Tracing Value Added In Global Production Chains*, National Bureau of Economic Research Working Paper No. 16426. Cambridge, Massachusetts.

Economic growth and US jobs may be adversely affected in the event of unsuccessful NAFTA renegotiations

Production-sharing arrangements in the context of global supply chains have important policy implications for the US-Mexico trade relationship, especially in light of the growing uncertainty surrounding any successful NAFTA renegotiation. This is because the fluid nature of specialized production in industries such as the auto industry may suffer compounding tariff costs each time intermediate products are sent across the border for development in the absence of NAFTA. Such high tariff costs may cause American firms to shift even more of the specialized production lines to Mexico to cap the final tariff bill, causing job losses in industries whose production would be outsourced abroad, and with ensuing detrimental effects on economic growth. This is in addition to the losses more typically ascribed to tariffs, including higher prices for imports and comparable domestic goods in the United States.

The complexities of NAFTA renegotiation and potential withdrawal

While all three countries have agreed that NAFTA should be renegotiated, the focus of each country in the negotiations is different.

[8] Koopman, Robert, William Powers, Zhi Wang, and Shang-Jin Wei. September 2010.*Give Credit Where Credit is Due: Tracing Value Added In Global Production Chains*, National Bureau of Economic Research Working Paper No. 16426, Cambridge, Massachusetts.

From the US perspective, the focus has been mainly based on trade imbalance and the loss of manufacturing jobs. Canada, on the other hand, agreed to renegotiate NAFTA, but is focused on other objectives, such as protecting NAFTA's record as an engine for job creation and growth, modernizing the agreement, cutting red tape for business and harmonizing regulations — measures that are all aimed at making NAFTA more progressive, particularly with respect to labor, the environment and gender.[9]

Mexico's objectives are similar to Canada's. Specifically, Mexico aims to: (1) have more, not less, trade; (2) strengthen North American competitiveness; (3) advance toward more inclusive regional trade; (4) take advantage of the 21st century economy to embrace innovation; and (5) promote certainty for trade and investment in North America.[10]

The evident discrepancies between the NAFTA objectives of the United States, Mexico and Canada have created a complicated renegotiation process.

Seven official rounds of negotiations have been completed and a permanent ongoing renegotiation process is still in place. While the parties have agreed to improvements in specific areas (i.e., transparency, competition, anti-corruption, customs procedures and trade facilitation), some sensitive topics, such as changes to automobile rules of origin, a sunset clause for the expiration of NAFTA every five years, investor-State dispute settlement, government procurement, and market access for agriculture, amongst others, continue to be unresolved as each party has differing views on the desired outcome based on its objectives.

While it is possible that the NAFTA parties may come to some agreement over the remaining issues, the discrepancies in their objectives could derail the overall process. In addition, political pressures, such as Mexico's presidential election on July 1 and the US midterm elections in November, increase the level of uncertainty with regard to a positive renegotiation. Finally, recent commercial actions have added complexity to the process, such as: (1) the imposition of US tariffs on Canadian and Mexican steel and aluminum products; (2) the study underway to assess impairment of US national security due to importation of automobiles and automotive parts – key pieces to the NAFTA region manufacturing economy; and (3) the respective retaliatory measures taken by Canada and Mexico.

Under NAFTA's Article 2205, any country may withdraw from the agreement six months after it provides written notice of its withdrawal to the other NAFTA countries. If one of the countries withdraws, the agreement would remain in force for the remaining countries.

[9] As stated by Canadian Minister of Foreign Affairs Chrystia Freeland at the opening conference of the renegotiation rounds.
[10] As stated by Mexico's Secretary of Economy, Ildefonso Guajardo.

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