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## **NAFTA Update: What happens when/if the US withdraws?**

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### **KEY POINTS:**

1. There is a risk that President Trump may choose to announce his intent to withdraw from NAFTA later this month, at or before the State of the Union address and his first-year anniversary.
2. This announcement would kick off a six-month waiting period, after which the president could formally withdraw from NAFTA, followed by a year in which he can lawfully begin to adjust tariff levels. The fate of non-tariff provisions of NAFTA, however, remains clouded by legal uncertainty.
3. Following formal withdrawal, the president could impose new, higher tariffs, aggressively apply trade remedies, or even (most dramatically) formally withdraw from the WTO in order to address the deficit. Mexico, Canada, and the broader trade world, meanwhile, would maneuver to minimize the damage done to their economies by any US action.
4. NAFTA withdrawal would be unprecedented and will usher in a period of deep uncertainty. Congress should try to exert its influence over this process, and lengthy litigation may also ensue. This uncertainty can create room for business to advocate for their interests to try to shape the broader post-NAFTA landscape.

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### **I. INTRODUCTION**

For at least 40 years, Donald Trump has been passionately and publicly critical of the US trade deficit and the trading partners allegedly at fault. Since becoming president, he has turned that rhetoric into action, not just pulling the US out of the TPP and demanding a re-negotiation of NAFTA, but also self-initiating trade actions against China on aluminum and intellectual property as well as a 232 national security case on steel/aluminum imports.

**What remains clear is Trump's singular goal of reducing the US trade deficit.**

This month, NAFTA negotiations head into a sixth round in Montreal. **We must brace ourselves for the likelihood that the US may formally initiate withdrawal from NAFTA at or around Montreal.** With his first year in office coming to a close and his first State of the Union just days later, the political window for a resounding

stroke against NAFTA may be too attractive to pass up.

If US withdrawal really is a question of when, not if, then **understanding the next steps and potential policy responses** will be crucial for helping decision-makers **navigate the murky 18-month process that follows**. The US has not unilaterally withdrawn from a trade agreement since 1866, and much ambiguity surrounds the legal and policy processes of NAFTA withdrawal.

**NAFTA withdrawal would be unprecedented and would usher in a period of deep uncertainty.** Yet, this very uncertainty **can create room for business stakeholders to advocate for their interests and try to shape the broader post-NAFTA landscape to competitive advantage.** This memo shows how.

## II. WITHDRAWAL TIMELINE

NAFTA withdrawal is governed by both the [NAFTA Implementation Act \(1993\)](#) and the [Trade Act of 1974](#) (Trade Act).

**NAFTA Article 2205 states:** “**A Party may withdraw from this Agreement six months after it provides written notice of withdrawal** to the other Parties.” Thus, actual withdrawal must await the running of the six months, and is not automatic; it requires a separate executive act of termination, which can come at any time after the six-month period, or never.

**The Trade Act lays out the authority and timetable under which the president may adjust tariff levels after withdrawal from a trade agreement.**

Read together, these provisions provide for the following timetable:

### ***Legal framework:***

- **Day 1:** Trump gives **written notice of intent to withdraw** to Canada and Mexico.
- **Day 180 (6 months later):** Trump **may formally withdraw** the US from NAFTA. Once he withdraws, he has 60 days to announce whether he will maintain existing tariff levels or revert to the MFN tariff levels established under the WTO. The Trade Act requires him to convene a public hearing at which interested parties may comment on proposed tariff levels.
- **Day 545 (12 months after formal withdrawal):** The **president may now impose new, higher tariff levels.** However, he is still bound by WTO commitments regarding (our extremely low) MFN and bound rates.

While the above **timeline regarding tariffs is fairly clear, the unwinding of the non-tariff provisions is shrouded in legal ambiguity.**<sup>1</sup> The basic question is whether the requirements now enshrined in US law by the NAFTA Implementation Act will disappear automatically on the date of withdrawal, or must require a

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<sup>1</sup> Likely areas for confusion include customs, trucking/transportation, intellectual property, or regulatory and standards provisions. For example, are innovations developed in Mexico or Canada still treated equivalently to those from the United States? Will the nearly 25,000 NAFTA visas still be issued by the US annually?

separate formal act of Congress to repeal them. It would **likely take years of litigation**, and perhaps a decision by the Supreme Court, to provide a decisive legal resolution. **Thus, there is considerable room for Congressional action and influence in the months and years ahead.** This provides stakeholders with room for enhanced advocacy or even legal action.

The next section of this memo looks at opportunities for action now and in the six months following formal notice of withdrawal; in the first 12 months following withdrawal; and after withdrawal.

### III. POLICY RESPONSE OPTIONS

#### A. From the present through actual withdrawal after Day 180

##### ***ACTION: Private Sector***

Until actual withdrawal pursuant to Section 2205, NAFTA remains legally in force, and this window offers the best opportunity to save it. **Interested parties should continue to attempt to preserve the agreement through political intervention, before and after any formal notice of withdrawal.** The business community from the US, Canada and Mexico has stepped up efforts with the Congress, state/local leaders, and directly with Vice President Pence and other White House actors. This should intensify.

##### ***ACTION: Congress***

In part due to the distraction of tax reform, Congress has so far taken little concrete action beyond consultation requests and expressions of concern, particularly emanating from agricultural states. At the same time, two policy responses are being quietly debated:

1. Congress could attempt to **revoke Trump's ability to unilaterally withdraw** from NAFTA through legislation. Trump would almost certainly veto such a restriction of his authority to act, making this option unlikely.
2. Congress could seek to **pass legislation delaying termination of NAFTA contingent upon an International Trade Commission (ITC) study on the economic impact to the United States of NAFTA withdrawal.** Senate Agriculture Committee Chairman Pat Roberts (R-KS) and others have voiced support for such an option. Once again, any legislation would be subject to presidential veto.

##### ***ACTION: White House***

**No matter what action Congress takes, Trump is most likely to continue to assert his authority to terminate** US participation in NAFTA during the six-month waiting period. Mexico and Canada have stated emphatically that they will refuse to negotiate under threat of withdrawal, but the Trump Administration might use this timeframe to try to force concessions. Meanwhile, **USTR and Commerce are likely to prepare plans for the president to reduce the US trade deficit**, particularly with Mexico.

The above-described legal ambiguity could push Trump to attempt to clarify matters by **forwarding legislation that would formally repeal the NAFTA implementing legislation**. Given the controversial nature of trade overall, this would be a difficult vote.

## B. Following withdrawal: Day 181 and after

If the president follows through on his threat to withdraw after the six-month waiting period, we will enter a period of profound uncertainty. The **Trade Act and our WTO obligations guide and limit the president's ability to adjust tariffs unilaterally to any level he chooses**, even after withdrawal. But what about the rest of our NAFTA obligations? Will they automatically disappear, as some argue, or will they remain until clarifying legislation is passed?

**Some elements of the post-withdrawal world are reasonably straightforward:**

- **NAFTA would remain in force for trade between Mexico and Canada**, although we suspect they would move to modernize NAFTA without us.
- **Trade with Mexico would be governed by WTO disciplines** across the board – not all bad given that some US proposals, like government procurement, are less liberalizing than the WTO. Tariff rates with Mexico would return to MFN levels, which are much lower for the United States (3% average) than for Mexico (average of 8%, but much higher for agricultural products), which will do little to reduce the Mexican trade deficit with the US.
- **Trade with Canada should be governed by the Canada-US FTA of 1989**, moving most tariffs close to zero (unless the president also seeks to withdraw from that FTA).<sup>2</sup>

**Regardless, withdrawal from NAFTA alone will not accomplish Trump's primary objective of reducing the US trade deficit.** As complicated as US NAFTA withdrawal would be, the real challenge could come when the Trump Administration comes to grips with the fact that low US bound rates at the WTO prevent raising tariffs indiscriminately to reduce imports. For example, the WTO bound rate for US tariffs on autos is a mere 2.5%. Ironically, withdrawing from NAFTA could lead to significant import surges from Asia, precisely what the Administration would like to avoid.

Due to post-withdrawal uncertainty, we may well experience what the [Financial Times has dubbed the “Zombie NAFTA,” neither dead nor alive](#). In this scenario, Canada and Mexico continue to abide by NAFTA obligations; US companies that rely on NAFTA continue to act as if the NAFTA implementing legislation is still in effect. Only definitive action by the courts or Congress could end this ambiguity. It will take swift and intense action from the business community, affected

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<sup>2</sup> A 1993 exchange of letters indicated that “suspension [of the FTA is] to remain in effect for such time as the two Governments are Parties to the NAFTA,” suggesting that the Canada-US FTA would become prevailing law. However, the Canada-US FTA is older and even less relevant to today’s market realities than NAFTA, raising doubts whether the Trump Administration would accept the bilateral FTA provisions on sensitive or outdated issues such as rules of origin. Ongoing disputes over aircraft, lumber, and dairy would persist.

**workers/farmers, local and state governments, and other stakeholders such as consumer groups to press for clarification and to shape the post-NAFTA trading environment.**

### **GOVERNMENT RESPONSE OPTIONS**

Below we outline the range of **options available to the Trump Administration and the governments of Canada and Mexico post-withdrawal:**

#### **United States**

1. **Do nothing**, i.e. declare that NAFTA is dead but live with WTO bound rates and a “Zombie NAFTA” for non-tariff disciplines. However, **substantial trade deficits with Mexico would likely continue** and put pressure on the president to act, perhaps in the following ways:
2. **Intensify application of trade remedies** (dumping cases, countervailing duties, safeguards, Super 301 and Section 232 investigations, etc.) permitting tariffs higher than WTO bound rates, without violating the WTO;<sup>3</sup>
3. **Raise tariffs beyond WTO bound rates**, therefore violating our WTO commitments and inviting retaliation/WTO action; or
4. **Go nuclear - formally withdraw from the WTO** and raise tariff rates beyond US bound rates, initiating a trade war and a profound period of global uncertainty in trade relations.

#### **Canada<sup>4</sup>**

1. **Do nothing**, i.e. live with “Zombie NAFTA.”
2. Rely on the **original Canada-US FTA**.
3. Renegotiate and modernize the Canada-US FTA.
4. **Renegotiate NAFTA** as a bilateral Canada-Mexico agreement.
5. **Raise tariffs and/or aggressively pursue remedy cases against the US to retaliate against the US.** While Canada has no interest in a trade war, it has already countered unilateral US duties on softwood lumber with a domestic subsidy to the same industry.

#### **Mexico**

1. **Do nothing**, i.e. live with “Zombie NAFTA.”

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<sup>3</sup> The US could aggressively pursue trade remedies against Mexican or Canadian goods. In November 2017, the Commerce Department self-initiated a case (against China) for the first time in a quarter century, demonstrating willingness to independently pursue tariff increases when deemed necessary. Indeed, any NAFTA scenario will proceed against the backdrop of heightened trade tensions with China, as the US challenges the country’s market economy status and pursues an intellectual property-related Super 301 investigation.

<sup>4</sup> The president could simultaneously give notice of withdrawal from the Canada-US FTA. The termination language in this FTA resembles that of NAFTA: “This agreement shall remain in force unless terminated by either party upon six-month notice...”

2. **Renegotiate NAFTA** as a bilateral Canada-Mexico agreement.
3. **Strategically deploy the \$2 billion in tariff retaliation rights** to which Mexico is entitled from the earlier NAFTA trucking dispute. Mexico has done this before to selectively apply pressure on products or districts/states of key members of Congress. Mexico could increase tariffs on select US agricultural products like apples or high-fructose corn syrup to encourage defense of NAFTA by key Trump constituencies.
4. **Mexico is considering proactively lowering MFN tariff rates on key industrial inputs to send a clear message to investors that the country will not allow US withdrawal from NAFTA to hurt its competitiveness.** While this would preserve US market access to Mexico for included products, Asian industrial inputs would also enjoy the reduced MFN tariff rate, eliminating the comparative advantage that US auto part manufacturers, for example, currently enjoy.
5. **Mexican officials have publicly stated that if the US abandons NAFTA, the country would reduce cooperation on key security issues** such as organized crime, drugs, Central American migration, and terrorism. Given Mexican national interests, we do not think Mexico will fully step back from collaboration in these areas. However, the **bilateral relationship would appreciably suffer**. This could have a profound impact on Mexico's presidential elections in July 2018, particularly if the Trump Administration intensifies attacks on Mexican immigrants or its focus on the border wall. If the latter were to occur before a US withdrawal, domestic political concerns could push Mexico to withdraw first, despite having zero interest in doing so.

#### **IV. THE BOTTOM LINE**

US withdrawal from NAFTA would usher in an era of profound uncertainty for industry and agriculture across North America, and disruption not seen since Smoot Hawley (1930). But the impact should come upon us slowly, taking months and perhaps years to clarify. **This long lead time provides opportunities for stakeholders to attempt to shape the outcome by intensifying advocacy efforts to support an optimal result.**

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