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## NAFTA Update: US Tariff Announcement Clouds NAFTA Outlook

June 4, 2018

### KEY POINTS:

- On May 31, the Trump Administration confirmed it would **impose tariffs on steel and aluminum imports from Mexico, Canada, and the EU** under Section 232 of the 1962 Trade Expansion Act.
- The announcement closely followed the US decision to consider new Section 232 **tariffs on vehicle and auto-parts imports, casting a pall over ongoing NAFTA negotiations.**
- Mexico and Canada **immediately announced that they would adopt retaliatory tariffs** on a range of US import products.
- McLarty's assessment of **scenarios for the NAFTA** talks is below. **US withdrawal around the June 8-9 G-7 Summit is a possibility; a more favorable outcome would involve a delay** in the talks until after the US midterms.

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### US Tariff Announcement Hits NAFTA Partners

On May 31, **President Trump signed two proclamations to implement tariffs on [steel \(25%\)](#) and [aluminum \(10%\)](#) imports from Canada, Mexico, and the European Union**, purportedly to protect America's national security under Section 232 of the 1962 Trade Expansion Act.

The announcement came on the heels of Trump's May 23 [announcement](#) initiating an unprecedented 232 investigation to consider imposing **new tariffs on vehicle and auto-parts imports**, including from North America.

[Canada](#) and [Mexico](#) responded swiftly to the US action on steel and aluminum, announcing they would apply **retaliatory tariffs on US products**, ranging from agricultural commodities, to consumer goods, to steel and aluminum. After a public comment period lasting through June 15, Canada intends to impose retaliatory tariffs of US\$12.8 billion as of July 1, while the timing of Mexican retaliation remains unclear. **Mexico, Canada, the EU, China, India, Russia, and Turkey** have already **challenged the steel and aluminum 232 at the WTO**. Following the 232 announcement, Mexican presidential frontrunner Andrés Manuel López Obrador, of the Morena party, (interestingly) called on the Mexican Government not to "fall into the trap of a trade war" and to maintain trade relations and dialogue with the United States to avoid hurting the Mexican economy.

## Tit-for-Tat Measures Threaten to Derail NAFTA Talks

While both Canada and Mexico have stated that they remain committed to a successful NAFTA renegotiation, the **negative impact of the steel and aluminum 232 along with the new autos 232 is obvious**. On May 31, Canadian Prime Minister Trudeau said he rescinded an offer to travel to Washington to try to reach agreement on NAFTA following US pressure to accept its contentious sunset proposal. In addition to enhanced tensions in trilateral relations, **the July 1 Mexican presidential elections and US midterms in November loom**.

It appears that **Trump believes** the steel and aluminum **232 gives him** not only **domestic political gain but also leverage in the NAFTA discussions**. **Instead, Mexico and Canada's negotiating flexibility is limited by recent Trump trade actions**.

### Congress Weighs In

Trump's decision to hit the EU, Canada and Mexico with 232 tariffs came after **Republicans in Congress had argued that the tariffs should target China rather than key allies and trading partners**.

In response, **House Speaker Paul Ryan [said](#)**, "I disagree with this decision... There are better ways to help American workers and consumers. I intend to keep working with the president on those better options." **House Ways and Means Chairman Kevin Brady** released a [statement](#) saying the tariffs "are **hitting the wrong target**." **Senate Finance Committee Chairman Orrin Hatch [said](#)** the tariffs "will have **damaging consequences** for consumers, manufacturers and workers."

**The following NAFTA scenarios remain possible, with varying probability:**

#### **Scenario 1: Negotiations Drag Out**

At this point, the **best-case scenario** is that the talks delay. It is **difficult to imagine a favorable outcome given the lack of US flexibility in particular and the distance between the parties**, including on critical issues such as autos rules of origin (RoO), sunset clause, investment, government procurement, etc.

Negotiations could drag out either through a **formal delay** until 2019 **or by the ministers mandating ongoing technical talks**, with ministers returning to the negotiating table only in case of an (unlikely) breakthrough.

Even with a delay, **we do not foresee a significant softening of the Trump Administration's concern over trade deficits, and the possible power shift in the US House is unlikely to simplify congressional consideration** NAFTA 2.0. Coupled with the probability of a less trade-friendly government in Mexico, merely **kicking the talks** until next year **does not necessarily improve the negotiating environment**. That said, delay would allow stakeholders additional time to defend NAFTA. However, it would also give businesses the opportunity to alter supply chains due to continued uncertainty.

#### **Scenario 2: US Withdrawal**

As it becomes clear that a NAFTA deal is untenable in the short term and with the United States increasingly isolated from allies, Trump may double-down on his aggressive approach by **withdrawing under NAFTA Article 2205**, which states: "A Party may

withdraw from this Agreement six months after it provides written notice of withdrawal to the other Parties.” **Timing of a withdrawal notice could coincide with the week of or after the June 8-9 G7 Summit in Quebec. Rumors abound that Trump is considering skipping the G7 Summit** following ministerial preparatory meetings last week during which Treasury Secretary Steven Mnuchin was widely criticized over the US decision to impose tariffs on steel and aluminum.

As with the steel and aluminum 232, **withdrawal could be motivated by perceived leverage in the talks and/or to seek advantage in the November midterm elections.** While they have taken (so far) the high ground on steel and aluminum, Mexico and Canada have both stated they will freeze talks if the US withdraws. This means **stakeholders would have the six-month waiting period** mandated by NAFTA article 2205 **to press for a mutually beneficial resolution** of the talks.

**If the USG withdraws, the US relationship with Mexico and Canada will deteriorate further.** Trump asserted Friday, “I wouldn’t mind seeing a separate deal with Canada, where you have one type of product, so to speak, and a separate deal with Mexico.” While he may hope that withdrawal would lead to this result, there would be **little political will in the short term to return to the negotiating table or for either to embark on a bilateral agreement** with the United States. **Economic pressure may force Mexico and particularly Canada to consider bilateral talks**, but each would **deepen its strategy to pursue aggressively deals with nations other than the United States.**

### **Scenario 3: “Agreement in Principle”**

With **trust at historic lows in North America**, an agreement in principle **feels like fantasy.** At the same time, the parties may see benefit in showing that NAFTA can be salvaged, perhaps to calm markets.

This is only possible if a RoO agreement on autos were reached (unlikely today) and if a hard 5-year sunset clause can be removed from consideration, in which case **a “skinny NAFTA” could be pursued.** “Skinny NAFTA” could mean many things, but most likely would be agreement on autos RoO, sunset, and already-closed chapters. Open areas, potentially IPR, dairy, ISDS, government procurement, dispute settlement, etc. could be:

- Included in a pared-down fashion;
- Carved out;
- Included as original NAFTA text;
- Included as TPP text (unlikely).

With political will, **congress could modify the TPA schedule** to allow for consideration of “Skinny NAFTA” in the lame duck. However, the **lack of consensus on Trump’s trade tactics** and on **key items like ISDS/government procurement make this extremely difficult** to imagine.

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