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The Economic Relationship between the United States, Canada and Mexico
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Getting North America Right for Prosperity and Security

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Economic relations across North America have prospered and deepened since the United States, Canada, and Mexico negotiated the North American Free Trade Agreement (NAFTA) twenty five years ago. North America has become a strategic foundation from which all three nations are building their prosperity and security.

The U.S. is very fortunate to have two neighbors committed to market principles and democratic values, with which it can work to compete more effectively against global trading powers and to counter threats from terrorism and transnational organized crime.

Since 9/11, and especially in the last decade, homeland security cooperation has greatly expanded in North America, while at the same time the private sector has expanded continental co-production and trading networks.

North America's geopolitical landscape has changed for the better with NAFTA. In particular, Mexico's relationship with its northern neighbors has been transformed.¹

We have the opportunity to improve North America's economic relationships with the negotiations to update the NAFTA treaty, and the doors are open to deepen security cooperation with our neighbors. We could also harm the U.S. greatly, however, if we mishandle the NAFTA negotiations. Pulling out of NAFTA, as the administration has threatened, could cost hundreds of thousands of US jobs, raise consumer prices, harm economic growth, create stock market turbulence², and help our major global trade competitors.

Particularly with Mexico, such a U.S. blow to our economic relationship would also undermine vital cooperation in fighting transnational organized crime and joint efforts to improve border security and to inhibit third country immigration. We could well also put a long-term chill into our bilateral relationship.

NAFTA's Value Added

Trade within NAFTA has grown almost four times since 1993. U.S.-Mexico trade has grown by six times. NAFTA trade totals some \$1.24 trillion a year.³ That is about \$2.4 million a minute. This is more than U.S. trade with the European Union (EU)⁴ and 1.9 times what the U.S. trades with China.⁵

NAFTA's trade and investment supports up to 14 million U.S. jobs.⁶ 9 million of those jobs are linked to trade with Canada.⁷ 4.9 million U.S. jobs are linked to trade with Mexico,⁸ which is seven times greater than the number of jobs (700,000) believed tied to US-Mexico trade in 1993.⁹

Canada and Mexico are America's top two export markets. A large majority of U.S. states have Canada or Mexico as a first or second trade partner. This trade is very important for U.S. farmers. In 1993, they exported \$8.9 billion in products to our two neighbors. Those sales were \$43 billion last year.¹⁰

Essentially, America's private sector has taken the opportunity of NAFTA to build a complex network of co-production, investment, and trade in which many products cross the border multiple times during the process of production. Production has become more efficient and thus less costly for American consumers, and NAFTA has helped the U.S. compete successfully with Asian production centers.

NAFTA also attracts investment from around the world. These investors do not just produce for the U.S. market, but they also produce for export outside of North America. It is important to recognize that just as the U.S. has built production networks with its neighbors, so have Germany, Japan and China.

A study done for the 20th anniversary of NAFTA found that the NAFTA partners are richer each year because of "extra" trade growth. This extra trade growth was estimated to be \$127 billion for the U.S., \$170 billion for Mexico, and \$ 50 billion for Canada.¹¹

Where did the Manufacturing Jobs go?

NAFTA has been criticized for shipping U.S. jobs to Mexico. Certainly, U.S. jobs have moved to Mexico. NAFTA critics argue that, at a minimum, steps should be taken to ensure better labor practices and higher wages in Mexico, and others argue for ending NAFTA.

It is important to recognize, however, that, according to serious economic studies, the vast majority of manufacturing jobs lost in this U.S. this century have been due to improvements in productivity¹² and competition from China.¹³ Many U.S. companies that moved jobs to Mexico also created jobs in the U.S., but those jobs often required higher skills than the ones eliminated.¹⁴ These economic studies did not find that NAFTA was a big contributor to the overall job losses, and NAFTA also seems to have produced new jobs as commerce expanded. But, that does not help those who lost jobs and could not find new ones during these years.

A big culprit here, I believe, is the absence of effective U.S. public policies and workforce development programs to help workers who lose jobs because of productivity/technology changes or trade. The U.S. needed and still needs strong workforce development and related programs that facilitate training, retraining, placement and new investments, when economic

disruption eliminates jobs. The need for such programs is only going to grow as technology continues to revolutionize the way we produce and work. Workforce development should become a priority action item in North America's agenda.¹⁵

Energy

Energy trade and production has also flourished under NAFTA. Private sector trade, innovation and investment have created a North American market that is highly interdependent and multidirectional. Energy security is within our grasp, if the three countries continue to develop cross-continental production, connectivity and policy coordination.¹⁶ Since Mexico's 2014 energy reforms, U.S. investments there have boomed, and the U.S. now sells more energy products to Mexico than it imports. Experts say that North America's energy trade is taking us toward liquid fuels self-sufficiency as early as 2020. They argue that this trend would be endangered if NAFTA and its investment protections were to end.¹⁷ The December 2017 U.S. National Security Strategy talks about the importance of "energy dominance." Working with our two energy rich neighbors is a good path toward achieving that goal.

Modernizing NAFTA: a major opportunity

NAFTA has not been trouble free. The countries have disagreed over a range of issues from sugar, meat, fresh fruit and dairy trade to trucking, temporary work permits, labor rights and tariffs on low value items. There is widespread agreement that NAFTA can be improved and modernized to take account of all that has evolved in the trade arena since 1993, when it was signed.

With this modernization, we have the opportunity to forge a gold standard agreement. This is more important because the United States is participating in only two of the 30 plus trade negotiations underway in the world: the renegotiation of NAFTA and of the U.S.-South Korea FTA.¹⁸

Others are moving ahead with trade accords. The eleven other members of the TPP negotiation plan to sign an agreement in March. The European Union reached an agreement with Japan in July. It is renegotiating its accord with Mexico, has a relatively new agreement with Canada, and is actively pursuing agreements with others.¹⁹ China is building new trade and investment relationships across Asia with its Belt and Road program and with regional and bilateral trade initiatives.

U.S. goods and services may well be disadvantaged in these markets by higher tariffs and new norms, standards and rules negotiated without the U.S. at the table. This adds additional importance to forging a high-standard agreement with our neighbors, sending a clear signal about the rules and norms expected for trade and investment in the North American marketplace. More broadly, the U.S. needs a trade policy that deepens and expands markets, as well as acting boldly with defensive measures against unfair trade practices by others. NAFTA is part of the U.S.'s trade offense, allowing the U.S. to confirm and secure its two largest

export markets and make all three economies more competitive by using continental supply and production chains.²⁰

While there are dozens of issues under active negotiation in the NAFTA talks, several important work-areas stand out:²¹

Technological advances: NAFTA needs to incorporate the technological advances in commerce since 1993. Cross-border data flows, e-commerce, and exports of digital products need to be incorporated into the agreement, for example.

Customs processes, requirements and points of entry: Inefficient customs and border processes and facilities cost North American businesses billions of dollars. These should be modernized and simplified by taking advantage of online platforms, modern scanning and processing, and better risk-mitigation programs for “trusted” goods and persons that improve security and efficiency. The NAFTA modernization will not solve all these issues, but it can significantly improve current practices and facilitate further improvements. Advances here can also open the doors wider for more participation by small and medium sized companies.

Rules of Origin: Building from industry data and feedback, negotiators should identify ways to increase North American content in manufactured goods and define more efficient ways to track that content.

Labor and the Environment: These issues should be integrated into the new treaty and updated to include provisions from more recent FTAs, including the draft TPP accord. The goal in the labor area is better protection of worker’s rights, with additional clout behind enforcement if rights are not respected. U.S. labor unions have targeted poor Mexican practices.²² Canada has called for improved U.S. labor protections.²³

Professional Services: The U.S. is a major exporter of services. It has surpluses with Mexico and Canada, but there is great potential for more U.S. exports. The agreement should include provisions to make it easier to provide services across borders, for example, with improved licensing and registration procedures.

Anti-corruption and transparency: The agreement should embody stronger commitments to counter public corruption, promote ethical standards and have more transparency in government practices. The press reports progress on these topics during the latest round of NAFTA talks.

Good regulatory practices: The agreement should deepen and expand the existing bilateral and trilateral dialogues among the three countries, establishing “best in class” practices for regulatory cooperation.

Controversial U.S. Positions and Proposals

There are normally difficult issues to negotiate in every trade agreement process. But, the U.S. has taken some particularly aggressive stances regarding NAFTA. The U.S. has repeatedly threatened to pull out of the agreement and offered positions that have been sharply criticized not only by Canada and Mexico,²⁴ but also by U.S. business²⁵ and farm groups.²⁶ The negotiators reported that they made some progress over the last week in Montreal, but there is still much work to do.

Trade Deficits: Unlike with China, the U.S. is not accusing Canada and Mexico of wide-ranging unfair trade practices. Rather, U.S. statements indicate that the fact that Mexico has a trade surplus with the U.S. is a sign that the agreement is unfair.

First, many economists argue that focusing on reducing deficits via trade agreements is not a path to success, as national deficits are much more closely linked to overall national savings and spending rates than to individual trade agreements.

Second, in free trade agreements the basic concept is that the rules are fair and that buyers and sellers then freely choose: it is not about managing the trade to assure balanced trade.²⁷ The U.S. had an overall trade surplus with the countries with which it has a Free Trade Agreement (FTA) in 2015, for example, but it had a deficit with some and a surplus with others.²⁸ That did not of itself make some of the agreements fair and others unfair.

Third, manufactured goods from Canada and Mexico have the highest content of U.S. goods of any U.S. trading partners – 25% and 40% respectively according to a 2010 study.²⁹ A Honda CRV assembled in Jalisco, Mexico has 70% Canadian and U.S. content, for example.³⁰ Motor vehicles exported from Mexico to the U.S. in 2014 had an estimated 38% in U.S. content³¹. When one takes account of American content in Mexican manufactured exports to the U.S., analyses have found that the real U.S. deficit is significantly reduced³² or eliminated.³³

Rules of Origin: The U.S. put forward a proposal to increase the required amount of “North American” content in motor vehicles to 85% from the current 62.5% and proposed a requirement that 50% of that content be from the U.S.³⁴ Secretary of Commerce Ross argued in an op-ed that the current situation is gutting U.S. manufacturing.³⁵

The North American auto industries and analysts counter argue that the U.S. proposal would endanger thousands of U.S. jobs and harm the auto industry.³⁶ They assert that North American content in vehicles produced in Mexico and Canada has, in fact, generally increased since 2011, that the U.S. auto sector is outperforming other U.S. industrial sectors, and that U.S. auto sector employment has increased nearly 6% annually since 2008, more than the employment increase in overall manufacturing. These analysts argue that the U.S. proposal would impair the global competitiveness of the auto industry.³⁷ There are, however, no doubt, other ways to improve NAFTA rules of origin, as the negotiators are reportedly now exploring. In Montreal last week, according to press reports the Canadians offered some ideas in this area, which the U.S. did not find as helpful.

Sunset clause: The U.S. has requested that a clause be included, which would automatically kill the treaty after five years unless all three governments agree to extend it.³⁸ U.S. businesses say that would wreak havoc with planning and investment and aid foreign competition.³⁹ Mexico and Canada are open to regular reviews of the treaty, but oppose an automatic opt-out.

Government procurement: The U.S. proposes to limit the amount of U.S. government procurement Mexican or Canadian firms can win to be equivalent to what U.S. companies win in their markets. Canada, Mexico and some U.S. companies have expressed opposition to this proposal.

Dispute settlement: The U.S. has proposed watering down NAFTA's provisions for settling disputes (Chapters 11 and 20) and eliminating chapter 19 in the current agreement. Mexico and Canada want to keep the mechanisms,⁴⁰ but are open to improvements. Canada is particularly firm on keeping chapter 19, which addresses anti-dumping and countervailing duty cases.⁴¹ U.S. energy firms are outspoken in support of keeping strong investor protections.

Agriculture: There are several contentious agriculture issues, including U.S. efforts to open Canada's dairy market and a U.S. proposal to protect some U.S. growers against Mexican fresh produce exports.⁴²

The Economic Costs of Leaving NAFTA

Whether a negotiating tactic or not, the Administration's threats to pull out of NAFTA are a bit like playing with fire: the costs of leaving NAFTA would be very high for all parties. A number of serious studies are now available estimating the economic costs of a U.S. withdrawal from NAFTA.⁴³ One of the studies, by Trade Partnership Worldwide LLC, provides a state-by-state breakdown of potential losses for each U.S. state output, exports and employment.⁴⁴ (Slides summarizing some of the findings are attached.)

Job Losses: These studies foresee U.S. employment losses ranging from 180,000 to 3.6 million in the first 3-5 years, depending on various post-NAFTA scenarios. The Trade Partnership Worldwide study also forecasts 200,000 to 700,000 fewer US jobs over the longer term.⁴⁵ The most affected sectors would be autos and agriculture/food, with textiles, services and other manufacturing also harmed. The impact in Canada is predicted as a loss of 125,000 to 1.2 million jobs. For Mexico, the job losses predicted range from 950,000 to 10.3 million.

GDP Impact: The studies all predict a decline in GDP. For the U.S. the decline could range from 0.09% or \$16 billion up to a decline of 1.2% or \$231 billion, depending on the scenario and assumptions made. One study estimates that U.S. consumers would face an added \$7 billion a year in higher prices.⁴⁶

Trade: The studies predict a drop in trade across the region and fewer U.S. exports and imports. The Trade Partnership Worldwide study predicts a drop of U.S. exports to the world of

2.5% to 5% and a drop of U.S. imports ranging between 3.6% and 7.5% in the first five years. That study finds the negative trade effect continuing in the longer term.⁴⁷

Trade Deficit: A study by Oxford Economics predicts that the trade deficit would not be improved by withdrawing from NAFTA.⁴⁸

States hit hardest: The U.S. Chamber of Commerce argues that an end to NAFTA would severely harm: Michigan, Wisconsin, North Dakota, Texas, Missouri, Ohio, Iowa, Indiana, Arizona, Nebraska, Pennsylvania, and North Carolina.⁴⁹

China and other competitors aided: The Trade Partnership Worldwide study predicts that an end to NAFTA would add 1.7 to 2 million new jobs in China, about 150,000 new jobs in Korea, some 290,000-790,000 jobs in Japan, and 120,000 to 308,000 new jobs in Germany, plus GDP gains for each of those countries.⁵⁰

Negative Messages to our Neighbors and the World

In Canada and Mexico, positive views of the U.S. already plummeted in 2017.

According to Pew polling, in Canada favorable views of the U.S. dropped 22% from 65% favorable during the last U.S. administration to only 43% favorable in the spring of 2017.⁵¹ This is reportedly the lowest score recorded at least since the early 1980s.⁵²

The change for the worse is much greater in Mexico, reflecting the stream of critical U.S. remarks about Mexico, the border wall, and Mexico's NAFTA role. Favorable views of the U.S. fell 36 points from 66 % favorable in the previous Pew poll. Only 30% of Mexicans polled in the spring of 2017 held a favorable view of the U.S. 65% of Mexicans polled held unfavorable views of their northern neighbor.⁵³ Subsequent, polling confirmed the negative Mexican public views of bilateral U.S.-Mexico relations. Pollsters report that these are the worst numbers in perception of the United States since at least 1991 and perhaps since the 1950s.⁵⁴

These opinions indicate the U.S. could face long-term damage in bilateral relations, especially with Mexico. Mexico and the U.S. were labeled "Distant Neighbors" in the 1980s because of their strained relationship.⁵⁵ Mexico has a long history of mistrust of the United States, which gradually had been overcome since the creation of NAFTA and with growing bilateral cooperation over the last 25 years.

Mexico is holding Presidential and Congressional elections in July. A U.S. decision to pull out of NAFTA or other moves viewed as humiliating and unfair toward Mexico could easily play into that election negatively for the U.S. and impact the policies and attitudes of the new Mexican President and Congress. The leading Mexican presidential candidate, Andres Manuel Lopez Obrador has already called for delaying the negotiations,⁵⁶ and some fear that he would take a more nationalist stance on NAFTA if elected.⁵⁷

It is also important to remember that the world is watching how we treat our neighbors and closest trading partners in this negotiation. If the U.S. is perceived to continue with a “take it or leave it” approach and not to recognize the “win-win-win” nature that should be built into lasting commercial relationships, how many other nations will be eager to engage in trade negotiations with the U.S.?

Vital Security Partners

Mexico and Canada are vital partners for enhancing U.S. homeland security, as well as its prosperity. Both are willing partners to work against terrorism and transnational organized crime. Border, law enforcement, homeland security and intelligence cooperation have expanded dramatically. Both countries are working with the U.S. identify potentially dangerous travelers before they get to U.S. borders. This collaboration is in line with priorities of the new U.S. National Security Strategy⁵⁸, but could well be damaged if the U.S. withdraws from NAFTA.

Defense and intelligence cooperation with Canada are rooted in common NATO membership, but cooperation related to homeland security issues has expanded dramatically in recent years. This is exemplified in the 2011 “Beyond the Border initiative”,⁵⁹ which has a broad agenda to enhance security against a range of threats while facilitating the legitimate flow of people goods and services. The basic idea is to extend homeland security work as far beyond the actual borders as possible.

A U.S. withdrawal from NAFTA could negatively affect this cooperation. As former Canadian Ambassador to the US, Michael Kergin put it January 26 at the Wilson Center “The real concern is if NAFTA goes badly and there is no interest in negotiating, would there be enough political backlash that would incline Canada to step back from security cooperation?”⁶⁰

Regarding Mexico, security cooperation began to deepen with the launch of the Merida Initiative in 2008.⁶¹ The Merida program is aimed at supporting Mexico in the fight against transnational criminal organizations and associated violence, as well as helping to strengthen its justice and law enforcement institutions and practices. That effort was expanded to include the Twenty First Century Border Initiative in 2010, which like the effort with Canada, is aimed at enhancing border security while supporting legitimate commerce.⁶²

Under Merida, the United States has spent some \$1.6 billion to help strengthen Mexican law enforcement and justice institutions, to improve Mexican capacities at its borders and to help strengthen communities beset by criminal cartels and gangs. American assistance has produced good results. At present, the U.S. is working hard with Merida funds, for example, to strengthen the forensic skills of Mexican officials in order that more criminals can be convicted successfully under Mexico’s new justice system.

The Mexican government has spent at least ten times what the U.S. has provided to strengthen its own law enforcement, intelligence and justice agencies. Along with Merida assistance, U.S. and Mexican law enforcement and homeland security agencies have built more effective

operational cooperation against criminal groups and activity. DHS and Mexican counterparts have, for example, signed a series of agreements, which, among other things, allow much better cooperation along the border on customs screening, provide for collaboration to assure the smooth repatriation of criminals, and facilitate the sharing information on criminal history and biometric information to help identify possible terrorists and criminals.

Today, the depth of U.S. cooperation with Mexico to strengthen border security, control migration, and dismantle transnational criminal networks is unprecedented. Mexican officials have stepped up efforts to identify potentially dangerous third country travelers and immigrants in coordination with American counterparts.⁶³ Mexican immigration officials have turned around hundreds of thousands of Central American immigrants headed to the US in recent years, despite criticism inside Mexico.⁶⁴

Cooperation against drug trafficking by criminal organizations further deepened in 2017 with a strategic action plan agreed between government ministers to attack the entire chain of illegal drugs from production to sales to financing and illicit money flows. This deeper cooperation is spurred on and made more important by the opioid addiction crisis in the U.S. and increasing violence in Mexico.⁶⁵ Unprecedented progress has also been achieved in military-to-military cooperation.⁶⁶

U.S. - Mexico bilateral cooperation against transnational organized crime and terrorism makes more sense than ever, but that cooperation is built on maintaining and deepening trust. Mexican officials worry in private that they will have neither the political space nor the support of their teams to deepen cooperation, if the United States ends NAFTA or is perceived as unfairly bullying Mexico. These officials say they want to deepen cooperation against criminal groups because it is good for Mexico, but with the Mexican presidential and congressional elections coming up in July 2018 and the sour Mexican public attitudes toward the United States, they are very concerned. As former Mexican Ambassador to the US Arturo Sarukhan put it at the Wilson Center on January 26: "If NAFTA collapses, all bets are off. It will have a profound, long standing effect ... future generations will ask 'who lost Mexico?'"⁶⁷

Conclusion

The United States has a great opportunity to conclude a "state of the art" trade agreement with its neighbors and largest clients. A modernized NAFTA can improve the existing agreement and increase jobs, trade, energy security, and prosperity, while making the U.S. more competitive in the world. To succeed, however, each of the parties needs to be able to convince their publics that the new agreement is good for them: that it is "win-win-win." This is a very big challenge given the breadth of subject areas under negotiation, the controversial proposals on the table, and the negative public atmosphere.

A new agreement is achievable, however, and worth the hard work. A good agreement would help reinforce the collaboration with both Mexico and Canada on important security issues, and it would tell the world that the U.S. is indeed open for business and trade.

The alternative path would cost the U.S. dearly in jobs, trade, competitiveness and security. It would harm our neighbors economically and further sour their views of the United States. It would make ensuring U.S. homeland security harder. Particularly with Mexico, we could see a return to the “distant” relationship that existed before NAFTA. Other potential international partners would become more hesitant about negotiating with the U.S., and our international competitors would benefit.

A much better outcome for the United States and for North America is to forge a renewed North American trade agreement and to continue to deepen security cooperation.

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