UC San Diego
SCHOOL OF GLOBAL POLICY AND STRATEGY
CENTER FOR COMMERCE AND DIPLOMACY
CENTER FOR U.S.-MEXICAN STUDIES

CONFERENCE ON "USMCA AND GLOBAL SUPPLY CHAINS: AN ASSESSMENT AFTER ONE YEAR"

Oct. 21–22, 2021

TAKEAWAYS

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The United States-Mexico-Canada Agreement (USMCA) replaced the North American Free Trade Agreement (NAFTA) on July 1, 2020 bringing key changes to rules of origin requirements, labor standards, and review periods. While these changes introduced new elements of uncertainty into the trading relationship between the U.S., Mexico, and Canada, the preservation of a North American trade agreement–relative to no agreement–was an important accomplishment and can be leveraged to mitigate other sources of uncertainty. This is the central message coming out of the Conference on USMCA and Global Supply Chains: An Assessment After One Year held virtually Oct. 21–22, 2021 at the Center for Commerce and Diplomacy at the UC San Diego School of Global Policy and Strategy. This summary represents our impressions from the discussion held between leading academics, business leaders, and policymakers during the conference, and does not represent the views of any single participant.

Four takeaways crystallized during the discussions:

1. Restoring credibility in the U.S. commitment to trade agreements must begin at home. The renegotiation of NAFTA, and rising economic nationalism more generally, created enormous uncertainty about the commitment of the U.S. to its trade agreements. Trading partners, in particular, Mexico and Canada, are increasingly skeptical of the permanence of U.S. trade agreements, given the depth of economic integration in North America and the apparent willingness of the U.S. to jeopardize it.

2. Policymakers should move expeditiously to clarify how the new rules of origin and labor standards will be interpreted to mitigate business uncertainty. It remains unclear how these new features of USMCA will be implemented and this has created unnecessary uncertainty, particularly for small and medium-sized firms in supply chains.

3. Policymakers should recognize the importance of USMCA for cushioning downside supply chain risk, as was demonstrated during the pandemic. As one participant noted, "not a single American factory was forced to close because of a lack of parts from Mexico."[1]

4. The absence of a coherent foreign policy toward China in each of the three countries is creating tensions within North America. These tensions can be mitigated by building on shared interests, such as securing and stabilizing supply chains.

We elaborate on these takeaways below and conclude with a reflection on the prospects for North American economic and political cooperation at this pivotal moment.

1. Restoring U.S. Credibility

The renegotiation of NAFTA cast major doubt upon the commitment of the U.S. to regional economic integration. It forced Mexico and Canada, as well as the U.S. Congress, to choose between having USMCA or no trade agreement at all. While this change in the *status quo* improved the bargaining position of the U.S., it also undermined its credibility on the permanence of its trade agreements.

The renegotiation of NAFTA meant that blowing up trade agreements entered the realm of possibility. Coming on the heels of Brexit and the wider populist backlash, it demonstrated that the U.S. was willing to use the

1. This statement has not been verified, but it speaks to the resilience of supply chains involving Canada and Mexico.

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provision in NAFTA that allowed a member to withdraw from the agreement with six-month notice – pushing the "eject button that you hope nobody presses." While trade agreements need an orderly and predictable process in which they can be updated, the renegotiation of NAFTA was neither orderly nor predictable.

Academic research has established that one of the main benefits of trade agreements, as measured by increases in trade and investment, is that they induce policy certainty.[2] Provisions like reciprocity and dispute settlement give businesses the confidence they need to make long-term investments. Predictable policies are key for businesses seeking opportunities abroad. This was confirmed by a business participant who noted that "when making major investments, throughout that cycle you need to trust that the rules are in place when you make those decisions and unfortunately, that has not recently been the case."

Uncertainty about the U.S. commitment to trade agreements is a domestic political economy problem that reflects, in part, the failure to provide sufficient compensation to the workers and communities that have been harmed by trade agreements. New research on the "NAFTA shock" supports this view.[3] U.S. counties that were more exposed to import competition from Mexico after NAFTA went into effect suffered large and persistent employment losses, as well as sharp increases in disability insurance claims.

Disability insurance is a poor substitute for trade adjustment assistance and active labor market policies that are designed to help distressed workers and communities adjust to the dislocations of trade. A consensus policy recommendation is that member governments need to devote more resources and attention to financing and facilitating adjustment in trade-affected manufacturing communities.

The broader point is that restoring credibility in the U.S. commitment to trade agreements has to begin at home– first within the U.S. economy, and second, within North America.

2. Clarifying Rules to Reduce Implementation Uncertainty

The automotive sector is a key part of USMCA, and rules of origin are substantively different from NAFTA.[4] NAFTA already had the most stringent rules of origin and the auto sector is struggling to determine how the new rules will be implemented. There are several unresolved issues. It is not clear what will be considered a local part, or whether parts will be considered whole units or a mix of separate parts, each requiring certification. Firms are struggling to comply with the new rules and certification is particularly challenging for small and medium sized firms. Auto makers across North America are concerned about how these calculations will be made, and the stakes are high because uncertainty about the rules has implications for intra-regional trade. It remains an open question whether North American producers will opt to pay duties at the relatively low most-favored nation rates on passenger vehicles and parts, rather than comply with the USMCA rules of origin. With the costs of compliance both high and uncertain, some small and medium sized businesses may choose not to participate in trade at all. As one participant put it, "when you face uncertainty, you have to be incredibly clear on your red lines."

Another source of implementation uncertainty involves USMCA's new and updated provisions for the protection of worker rights and the enforcement of labor commitments. Surprisingly, academic research is very thin on the impact of labor provisions. USMCA rules prevent a disputing party from blocking the formation of a labor panel; they also establish a new "Rapid Response Mechanism" to facilitate independent panel investigations

2. See, for example, Jeronimo Carballo, Kyle Handley and Nuno Limao, "Trade Cold Wars and the Value of Agreements during Crises," Vox EU, March 16, 2018.

3. Jiwon Choi, Ilyana Kuziemko, Ebonya L. Washington, and Gavin Wright. "Local Economic and Political Effects of Trade Deals: Evidence from NAFTA." NBER Working Paper No. 29525, November 2021.

4. The new rules require 75% regional content (up from 62.5%) and, for the first time in any trade agreement, 40% of work on passenger vehicles must be performed by workers earning at least $16 per hour. Certain "core" auto parts will also need to qualify as originating in the USMCA region for the first time, and 70% of steel and aluminum purchases must be made in a USMCA country. Three certificates are now required in order to claim duty free treatment: (1) a general USMCA certification, (2) a high wage labor certification, and (3) a steel and aluminum certification.

at covered facilities. USMCA also includes for the first time migrant workers and recognizes their vulnerability and their protections. The discussion highlighted how little is known about the impact of labor provisions in trade agreements. The consensus view is that academics should give more attention to the impact of labor provisions on trade, and their role in trade agreements more generally. How effective are these provisions in resolving labor disputes and providing predictability to trade agreements?

3. A Crucial Supply-Chain Cushion During the COVID-19 Pandemic

Do trade agreements help minimize and contain the disruptions from exogenous shocks like the COVID-19 pandemic?[5] In his public remarks, keynote speaker Christopher Landau, U.S. Ambassador to Mexico from 2019 to 2020, presented the case. When the pandemic hit, decision makers and business leaders in the U.S. and Mexico were confronted with the reality of how deeply integrated their economies had become. Supply chain operations did not maintain large inventories because they had become accustomed to just-in-time sourcing within the bloc. Thus, the main challenge was to keep the border open to commerce. As Ambassador Landau said, "If the U.S. border with Mexico had closed to commerce, the U.S. economy would have gone into recession in less than a week."[6]

Although it was a scramble to keep borders open, the networks established by NAFTA and USMCA made it possible. U.S. diplomats in Mexico worked closely with state-level officials to determine essential industrial activities in supply chains. These efforts paid off as "not a single American factory was forced to close because of a lack of parts from Mexico," according to Landau.

The trade agreement can be improved to meet the challenges of future crises. During the pandemic, Mexico did well by relying on its federal system to allocate discretion to state authorities with knowledge of supply chain activities. Luck also played a role as the pandemic hit North America relatively late. What is needed is an institutional process within USMCA to prepare for the next unanticipated crisis. A commission composed of representatives from all three countries who understand supply chains could help get the ball rolling. Overall, leaders of the three countries should view USMCA as an instrument to help address the challenges of fundamental uncertainty. This, in turn, can help restore confidence in the broader regional relationship.

4. Credible Commitments on Economic Relations with China

Just as NAFTA was shaped by global conditions, so too is USMCA. Robert Zoellick, former President of the World Bank, highlighted the role of global factors in his public keynote address. In 1990, he noted, the U.S. was focused on the end of the Cold War and "the Bush administration recognized that the idea of North America had to be an important part of a post-Cold War world." Unlike Europe, which integrated under the model of shared sovereignty, all three North American nations have a strong sense of independence. The European model will not work here.

Nevertheless, "NAFTA was much more than a trade agreement," noted Zoellick. It was a framework to connect Mexican institutions and society to U.S. and Canadian business, professional, social, and political networks. It encouraged deeper cooperation and attention to shared interests. It helped Mexico commit to economic openness and it created a common front on many global issues.

As Ambassador Zoellick put it, "Over 25 years that idea took many practical forms. Many Mexican economic institutions became world class competitors and Mexico recast its international orientation with a global perspective. Many Mexican officials rose to positions of power in international organizations. Mexico and Canada became key allies to the U.S. at the global level and the Mexican experience became a model for other countries around the world."

The foreign policy positions of Mexico, Canada, and the U.S. are moving out of alignment, creating challenges for dealing with China. Part of this reflects U.S. economic nationalism and the shadow it casts over the permanence of U.S. trade agreements (see above). From the Canadian perspective, "the fact that the U.S. is not a reliable partner makes Canada, as a middle power, understandably nervous." In response, Canada is actively seeking alternative trading partners in order to lessen its

5. Academic research shows that trade agreements reduce the likelihood that nations will raise tariffs when exposed to negative shocks. See Jeronimo Carballo, Kyle Handley, and Nuno Limão. 2018. "Economic and Policy Uncertainty: Export Dynamics and the Value of Agreements." NBER Working Papers 24368, National Bureau of Economic Research, Inc.

6. According to the National Bureau of Economic Research, the U.S. economy entered into recession in March 2020, due to the lockdown orders issued in many parts of the country, travel restrictions, and general fear of the coronavirus.

"The successful–if unexpected–renegotiation of NAFTA indicates that all three nations still prefer a regional trade agreement to no agreement at all."

economic dependence on the U.S. and reduce U.S. influence on Canada's relationship with China. No China strategy has materialized in Canada so far but a provision in the USMCA that requires a member to notify the other two members if it plans to sign an FTA with China or other non-market economy suggests growing tensions within North America over China. With China's application to enter the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), this may force Canada and Mexico into a choice between USMCA or CPTPP with China.

In Mexico, China has been increasing its presence both economically and culturally for years. It has been Mexico's second largest source of imports since 2003, just as the U.S. share of Mexico's imports has decreased by 20 percentage points. "Intraregional trade within NAFTA has fallen while China became its fourth informal member," noted a participant. This could be a source of tension if Chinese imports are subsequently exported to the U.S. in ways that evade rules of origin. But Mexico also does not have a real plan for its relationship with China.

The solution should begin with three-way discussions that reinforce the U.S. commitment to free trade and build on areas of consensus toward China. The pandemic has demonstrated that it is vital to have reliable supply chains for essential goods and improving regional integration with USMCA would be a good project for all three countries. In the meantime, the member countries should refrain from petty trade disputes that irritate their closest trading partners. The North American region has to discuss what to do with China as a whole and such measures only fuel uncertainty and resentment.

USMCA: Looking Forward

The successful–if unexpected–renegotiation of NAFTA indicates that all three nations still prefer a regional trade agreement to no agreement at all. But there are other opportunities that go beyond this common denominator. One opportunity lies in building on the *ad hoc* cooperation witnessed during the COVID-19 pandemic to institutionalize a process within USMCA for responding to exogenous shocks. An important auxilairy benefit of trade agreements is that their networks can be mobilized to deal with unforeseen shocks, such as pandemics, extreme weather events, and cyber-attacks. The pandemic was a testing ground for how to keep supply chains operating during a health emergency. The lessons learned should be institutionalized.

One area where more research is needed is on the effects of labor standards in trade agreements. Labor standards provisions are increasingly common in trade agreements, but academic research on their impacts remains insufficient to guide policymakers.

China remains an area in which all three countries are struggling to define policy. This is an opportunity inasmuch as shared interests could be a basis for reviving regional cooperation. Business, diplomatic and academic networks built from the implementation of NAFTA until today, can be leveraged to help navigate future relations with China.

Finally, and most importantly, the USMCA provides an opportunity to reassess the correct balance between domestic sovereignty and credibility in trade agreements. Trade agreements will face credibility problems going forward unless member countries confront underlying domestic sensitivities. Leadership within USMCA, and more broadly at the multilateral level, such as the WTO, is crucial to finding a new balance between sovereignty and economic openness. This leadership cannot be accompanied by nationalism. There is a middle ground between complete openness and autarcy that needs to be defined and negotiated.

This Conference was organized with the support of Otay-Tijuana Venture, L.L.C.

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