The new NAFTA: Mexico most-unfavoured nation?

Blog post by Senior Associate Guillaume Ferlet, 7 September 2018

Something rather important flew under the radar last week, as the US secured a deal with Mexico on NAFTA. With most of the coverage focused on the revamped rules of origin for auto trade, little light was shed on the Trump administration's other achievements in the auto sector. The deal struck with Mexico reportedly includes a clause allowing the US to charge more than its most-favoured nation (MFN) tariff on auto imports from Mexico which fail to meet the new rules of origin.

Last week's deal has not been published, so much remains unclear, in particular the possibility that this rule could only apply to the production of car factories built in Mexico after the new NAFTA comes into force. But what is certain is that if the US can avail itself of such a clause, it will clearly aim a lot higher than the 2.5% MFN ceiling it has committed to in its WTO tariff schedule.

This is a particularly novel and creative way to treat non-compliance with rules of origin. It is also a reflection of the deep frustration felt in the Trump administration at the US's lack of tariff leverage at the negotiating table, after decades of multilateral rounds have brought American tariffs to an all-time low.

For businesses, the practical significance of this new approach can hardly be understated. It means that carmakers who do not reorganise their North American supply chains to comply with the new NAFTA rules of origin – likely involving some relocation of activity to the US – will be hit by a new tariff at the US border. Difficult decisions lay ahead if the new levy set by Washington ends up well above the mere 2.5% which carmakers were expecting to face and, for many, willing to pay to continue with current cross-border arrangements.

Yet, the wider implications of this aspect of the NAFTA renegotiation might be for the multilateral trading system at large. In essence, Washington has strong-armed a trade partner into accepting tariff increases that violate the US's own liberalisation commitments at the WTO.

The Trump administration might argue that there is nothing to prevent it if all parties around the table agree to it, but WTO agreements and case law indicates that inserting such a provision in an FTA contravenes the organisation's rules. Simply put, the US has boldly stepped into a territory where it will seek to depart from the WTO rulebook whenever it needs flexibility at the negotiating table.

This begs the question of how committed to WTO reform the Trump administration can be, when it does not seem to consider itself bound by multilateral rules as it seeks to renegotiate the commitments made by previous US administrations in trade relations. It also begs the question of what it would pursue in WTO reform negotiations, should it choose to engage in these actively.

The EU's drive to reform the organisation has so far been based on the premise that tightening the WTO rulebook to impose stronger discipline on state intervention in China and other state capitalists who free ride on the loopholes of the current system would placate Trump's concerns and preserve US buy-in for the rules-based trade order. But if the Trump team will happily push for such constraints on China, the risk is to misread what else they would seek to extract in the process.

What the NAFTA denouement demonstrated in this regard last week is that the Trump administration wants the policy space to erect new tariff barriers around the US and discourage US firms from outsourcing and investing abroad. This is where the EU, but international businesses as well, should be concerned that WTO reform might actually be leveraged by Washington to reverse the multilateral liberalisation process and reacquire policy space on a wide scale.