The thorniest NAFTA issue

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With three rounds of the North American Free Trade Agreement (NAFTA) renegotiation now in the books, negotiators are no closer to a successful completion of a revised agreement. While much of the media focus has been on a web of thorny issues such as labor standards and dispute mechanisms, what is often missed is the real sticking factor: automotive rules of origin.

Taking the negotiators at their word in their *Trilateral Statement on the Conclusion of the Third Round of NAFTA Negotiations*, progress on other matters, such as on the small and medium-sized enterprises chapter and the competition chapter, has been speedy. However, as Canada's Foreign Minister, Chrystia Freeland put it, these are the easy "bread and butter" issues.

And while issues such as labor standards and investor dispute settlements will no doubt remain contentious, they are unlikely to stir the level of negotiators' resolve the way rules of origin will. As Canadian Finance Minister Michael Wilson once put it: "Rules of Origin are very, very complex. You don't want to know about them. They're terrible things to deal with."

What makes the automotive rules of origin so special? It all dates back to the original NAFTA negotiations. Just as it is today, the automotive industry is a critical sector of the North American economy, and the negotiators were empowered to protect it.

To accomplish this, the drafters assigned a high NAFTA originating regional value content (RVC) requirement of 62.5 percent to automobiles, when compared with other goods that have only a 50 percent RVC requirement. That means automakers would have to ensure that 62.5 percent of the components used to make an automobile would come from within North America.

The negotiators also installed special rules of origin to automobiles and their components – featuring the unique concept of "tracing".

Tracing requires the non-NAFTA content of certain listed materials to be tracked through each tier of the automotive supply chain. As goods are transferred from one supplier to the next, the "traced value" is identified and reported. The intent is to prevent "rolling up" of content obtained from outside of North America.

For example, with tracing in place, engine components purchased from Asia and manufactured into a complete engine in Mexico must be accounted for in the qualification of the vehicle, rather than roll up the engine to 100 percent NAFTA content.

For non-automotive NAFTA products and for products in other free trade agreements, the substantial transformation of a material in the NAFTA territory permits the next tier in the supply chain to count (or roll up to) the entirety of that good's value toward the qualification of the next good in the supply chain.

So, what is the issue now? First, the current NAFTA agreement requires only listed goods to be traced. The listed goods are primarily high level automotive parts. Raw materials, however, are not listed and may be "deemed originating" no matter their origin. So, components made in a NAFTA territory from Chinese steel or aluminum positively contribute toward the 62.5 percent RVC. Second, the tracing list is outdated. Since being created more than 23 years ago, high-value components such as infotainment systems — not contemplated in the original NAFTA negotiations — have been predominantly sourced from non-NAFTA suppliers but deemed as originating from within NAFTA.

In addition to issues with the tracing list, the US trade deficit is a key aspect of the NAFTA renegotiation. US opponents of NAFTA maintain the 1994 warnings of a growing US trade deficit have been borne out. According to the US Department of Commerce report *US-Produced Value in US Imports from NAFTA*, the percentage of US-produced content in manufactured imports from Mexico and Canada has declined precipitously.

For example, the level of Chinese materials in Mexican products imported by the United States increased from 0.3 percent in 1995 to 6 percent in 2011. The share of materials from all non-NAFTA sources increased from 14 percent to 27 percent. According to Commerce Secretary Wilbur Ross, "the trend of Mexico and Canada using more non-US-made parts and components may mean even more bad news for American producers."

The Cato Institute, however, takes exception to this view in its article *A Newer NAFTA*, noting "trade deficits are complex, and generally reflect macroeconomic factors rather than trade agreement provisions." Cato maintains the benefits realized across the NAFTA region should not be negated. About 34 percent of total US exports go to Canada and Mexico making NAFTA a critical component of the US economy.

Mexico and Canada also think the US emphasis on the trade deficit is misplaced. Mexico believes the deficit figure ignores the benefits accruing to US manufacturers, workers, and consumers through lower costs that keep the United States and the entire integrated region competitive with other regions. Canada's actions meanwhile demonstrate its belief that more free trade agreements like its newly launched Comprehensive Economic and Trade Agreement (CETA) with the European Union is essential to economic prosperity.

What is subject to change? There is a possibility the automobile RVC requirement of 62.5 percent could increase with some media outlets suggesting the requirement could spike to 70 percent or more. In addition, US negotiators may require a portion of the RVC — possibly as much as 35 percentage points — be comprised of US content. It is on this point that Mexico and Canada may balk and possibly bring the talks to an impasse.

In addition, automotive tracing rules may be altered to limit non-NAFTA goods from being deemed originating. This is a tricky matter, as the tightening of the tracing rules necessarily mean the required RVC is more difficult to achieve and, if combined with a higher RVC, it will make the NAFTA qualification of automobiles all the more challenging. Automakers across the NAFTA territory would need to reevaluate business plans that depend on the cost avoidance afforded by NAFTA. This would not only be disruptive to operations, but may result in a reconfiguration of supply chains, leading to divestment of infrastructure such as manufacturing facilities, which would in turn result in potential job losses and higher prices.

As the renegotiations proceed in the coming weeks, there will be a wide range of critical issues that will be discussed and analyzed but it is the automotive rules of origin that are most likely to determine the success or failure of the talks, and the issue that should be watched most closely.