

## CUSMA: Revised, Signed, & Ratification Coming

- Today, the heads of government of Canada, the United States, and Mexico signed the successor agreement to NAFTA, following the September 30, 2018 release of the accord's draft text. The new pact, which will be known as the Canada-United States-Mexico Agreement (CUSMA) in Canada, and USMCA in the US, is set to come into effect on January 1, 2020. The side letters that protect Canada and Mexico from possible US tariffs on the auto sector come into force immediately.
- We anticipate that CUSMA will be ratified by each of three countries' legislatures around mid-2019 and that any additional demands from the US Congress would be handled in side letters rather than necessitating a re-opening of the Agreement.
- The text of the Agreement released today is mostly unchanged from the initial version published at end-September, though there are two key revisions: (1) the language has been refined in the side letters on vehicles and parts, and in an annex to Chapter 2 of the Agreement, Mexico's exemption from higher duties on non-originating vehicle exports to the US has been made stricter; and (2) a footnote on labour rights has been added in response to US Congressional Republican opposition to protections for sexual orientation and gender identity in the workplace. There appear to be some additional small changes whose potential import requires further study.
- Canada and Mexico have still not received an exemption from US tariffs on steel and aluminum products as the US presses for binding quotas that would cut imports from the two countries. Talks will continue and we expect that these tariffs will be lifted prior to the formal ratification of CUSMA in both countries.

Prime Minister Trudeau, and Presidents Peña Nieto and Trump have put pen to paper on the Canada-United States-Mexico Agreement (CUSMA) on the sidelines of the G-20 Summit currently underway in Buenos Aires, Argentina. The signature of the Agreement sets off the next steps in the formal ratification of CUSMA through the three countries' legislatures, which we expect to conclude sometime around mid-2019 followed by an entry into force of the Agreement on January 1, 2020.

### AUTO SIDE LETTERS REFINED

Canada and Mexico also signed side letters with the US—that become effective immediately—which exempt up to 2.6 mn passenger vehicles a year from each country from possible US 'national security' tariffs on autos. Canada and Mexico are each set to export around only 1.8 mn passenger vehicles, respectively, to the US in 2018 (chart 1). While we do not foresee Canadian exports reaching their side-letter ceiling any time soon, Mexican vehicles may reach the 2.6 mn limit sometime in the latter years of the next decade if production and exports maintain anything close to their current trajectories. The side letters also exempt from new US tariffs up to USD 108 bn

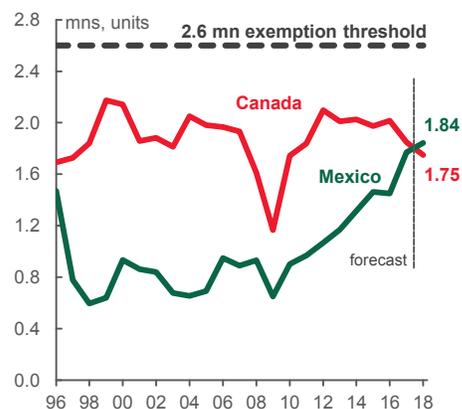
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Chart 1

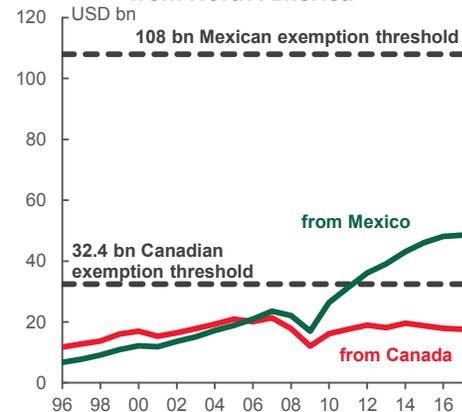
**US Imports of Passenger Vehicles from North America**



Sources: Scotiabank Economics, US ITC.

Chart 2

**US Motor Vehicle Parts Imports from North America**



Sources: Scotiabank Economics, US ITC.

and USD 32.4 bn in auto part imports from Mexico and Canada, respectively (chart 2). Finally, the side letters completely exempt light trucks from the possible US auto tariffs.

The auto side letters have been altered from their initial draft version to specify that vehicles or parts that fall below the export threshold are subject to preferential tariff treatment under NAFTA or CUSMA, as applicable at the time of importation. The duty rate applied on vehicles that don't meet NAFTA's or CUSMA's rules of origin (ROO) shall not exceed the present US's most-favoured nation (MFN) rate of 2.5% on passenger vehicles and 25% on light trucks. Thus, the side letters now clarify that auto imports do not have to meet either NAFTA's or CUSMA's rules of origin requirements to be exempt from future 'national security' tariffs.

### MEXICO NON-COMPLYING AUTO EXEMPTION MADE STRICTER

Up to 1.6 mn Mexican passenger vehicle exports may qualify for a duty rate no higher than 2.5% MFN rate in trade with the US on the condition that they have a regional value content share of 62.5% or higher. This clause is similar to, but stricter than, the version included in the September 30 draft of CUSMA, which stipulated that vehicles had to meet NAFTA's rules of origin requirements for this semi-preferential treatment.

The most recent and initial drafts differ in that under the first iteration Mexican producers could leverage NAFTA's full set of provisions; this has now been circumscribed. One of these provisions allowed for vehicles to have only a 50% regional value content (RVC) share—instead of NAFTA's standard 62.5%—for up to five years from the date when the first unit of a new model is produced, and for up to two years in the case of a vehicle produced at a refitted plant, to be deemed originating and thus NAFTA-compliant.

This modification means that new Mexican vehicles that would have an RVC between 50% and 62.5% on January 1, 2020—up to 220k such units were exported in 2017 according to our estimates—could be vulnerable to a, still-unlikely, increase in the US's MFN rate on passenger vehicles.

### OTHER CHANGES AND QUERIES

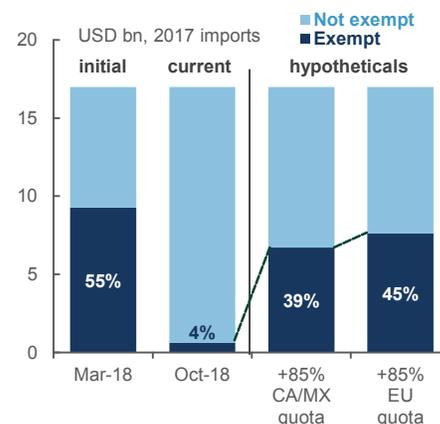
The most recent draft of CUSMA also includes a footnote that stipulates that the US is not required to take additional legal action, such as modifying the *Civil Rights Act*, to make good on CUSMA's language prohibiting workplace discrimination on the basis of sexual orientation and/or gender identity. The footnote effectively nullifies the related protections in the main CUSMA text. It was likely added to appease Republican members of the US Congress who had indicated these protections could force them to oppose ratification of the Agreement.

The new text also includes what appears to be new language on environmental cooperation that institutes a successor to NAFTA's North American Agreement on Environmental Cooperation (NAAEC) and a trilateral commission under CUSMA's environmental chapter. It's not clear, however, that this represents any substantial change compared with NAFTA or the September 30 draft of CUSMA. We will look for technical briefings from the three countries' governments for further clarity on this issue.

We had expected to see revisions to CUSMA's language on the *de minimis* threshold (DMT) for the application of tariffs and taxes on small cross-border shipments. The Agreement's wording appears to limit the new looser DMTs to express deliveries—such that packages delivered by regular national postal services may not benefit from these new, higher

Chart 3

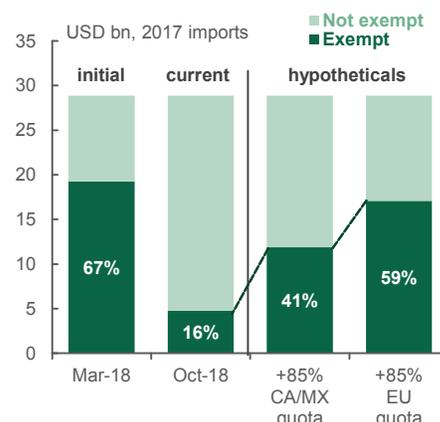
#### US Aluminum Tariffs Exemptions



Sources: Scotiabank Economics, US ITC.

Chart 4

#### US Steel Tariffs Exemptions



Sources: Scotiabank Economics, US ITC.

**thresholds for the application of duties and sales taxes.** This could significantly reduce the utility of the new DMTs for small businesses that principally use national postal services for cross-border shipments. Again, technical briefings should clarify this.

**STEEL AND ALUMINUM TARIFFS STAY IN PLACE**

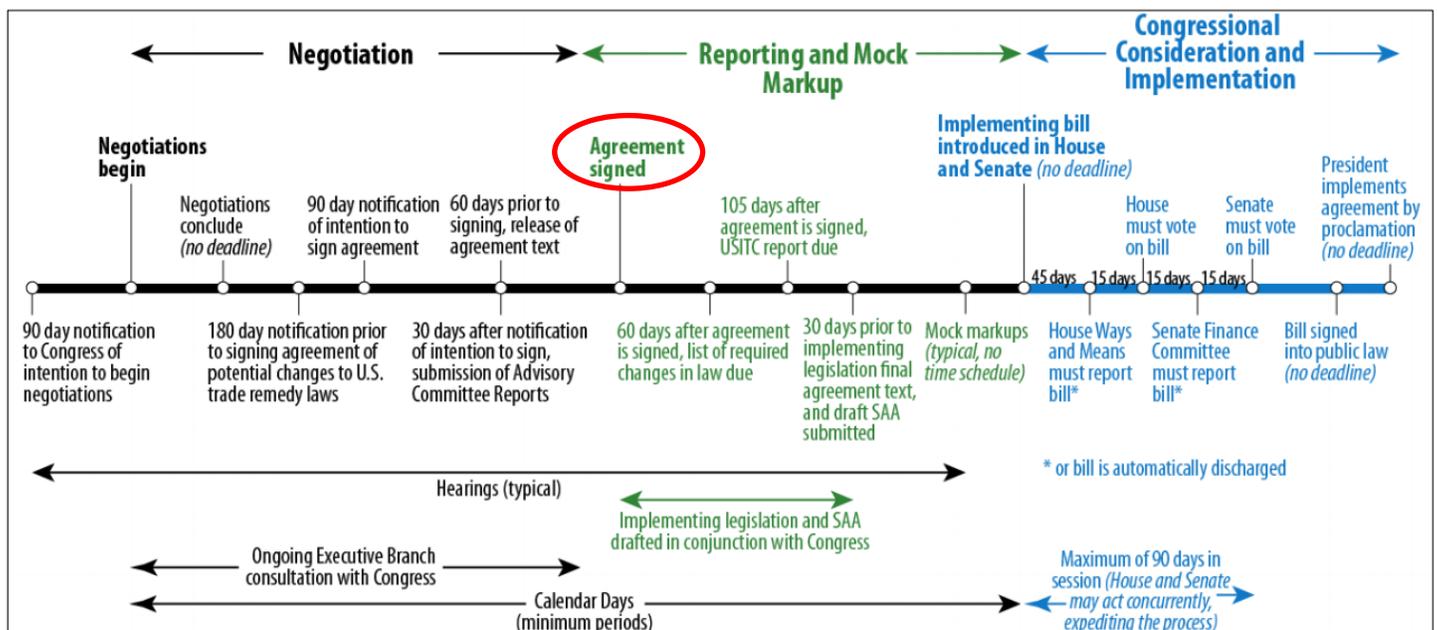
**US tariffs on steel and aluminum imports from Canada and Mexico were not lifted upon signature of CUSMA despite earlier US assurances that they would indeed be dealt with once the re-negotiation of NAFTA was complete.** US Trade Representative Robert Lighthizer has, however, indicated that discussions will continue with representatives from Canada and Mexico to address the possibility of lifting the metal tariffs. The US is said to be pressing Canada and Mexico to agree to quotas that would limit steel and aluminum exports to the US to a specific share of recent years’ shipments, much as Argentina, Brazil, and South Korea have done. Australia is at present the only country that has obtained an exemption from these tariffs without agreeing to a quota regime. The small set of countries that have been granted tariff exemptions account for just 4% and 16% of US aluminum and steel imports, respectively (charts 3 and 4).

**The steel and aluminum tariffs are not compatible with CUSMA’s auto rules of origin, which specify that vehicle exports shall qualify for duty-free treatment only if automakers purchase 70% of their steel and aluminum from North American sources.** Although there are multiple grounds for the removal of these tariffs, including their illegality and the costly inefficiencies they impose on North American manufacturing, their internal consistency with CUSMA’s auto ROOs should be enough to justify lifting them immediately.

**RATIFICATION WILL TAKE AT LEAST SIX MONTHS**

Ratification of CUSMA should proceed smoothly in Canada and Mexico, where the governing parties have legislative majorities. In the US, the Congressional ratification process is more time-consuming and speculation that it could be carried out in the lame-duck session is misplaced: it is likely to take at least six months (figure 1). In the new Congress, the Democratic-controlled House is unlikely to hand President Trump its sign-off on the Agreement without extracting some conditions. A handful of Democratic Senators and Representatives has already indicated that they don’t think the Agreement’s labour and environmental standards are sufficiently strong; they also have worries that CUSMA adds too much strength to some intellectual property protections. If these concerns gain traction, they are likely to be dealt with in side letters or annexes to the Agreement, not a wholesale re-opening of negotiations. The existing NAFTA side letters on the environment and labour standards came out of similar processes in order to win Congressional approval from House Democrats in the first years of Bill Clinton’s presidency.

Figure 1



Source: CRS.

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