Global macro matters

The bumpy road to NAFTA 2.0

Vanguard research | Joseph Davis, Ph.D. | March 2018

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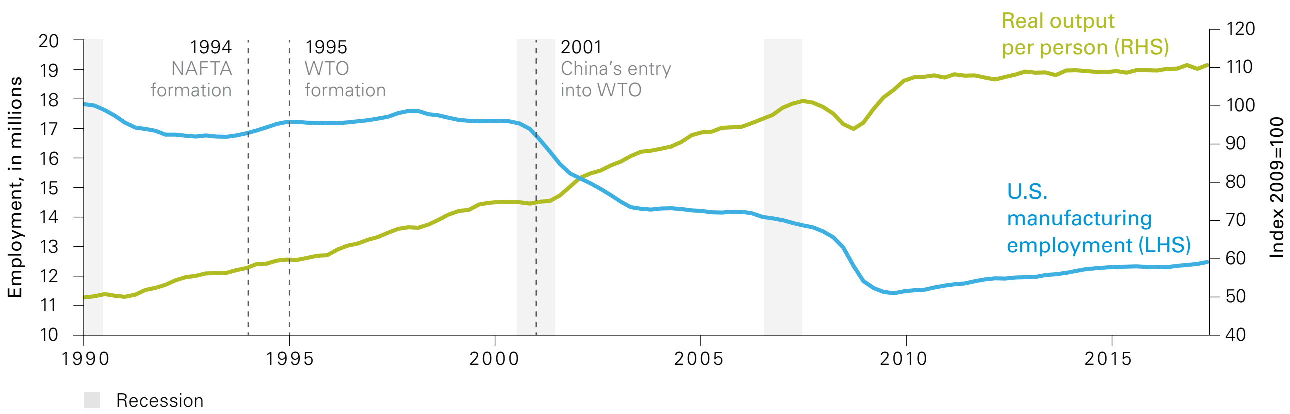
The North American Free Trade Agreement has supported competitiveness among the United States, Canada, and Mexico by enabling economic integration in key industries, though the gains have been realized in different sectors among the trading partners. Current NAFTA renegotiations present an opportunity to broaden industry coverage and update labor and environmental standards based on the modern economic landscape. Despite delays in the talks, an eventual deal by early 2019 is much more likely than NAFTA's termination and will promote continued integration within the region and competitiveness in global markets.

NAFTA bolstered competitiveness during rapid globalization

Since its signing in 1994, NAFTA has faced criticism for its role in the notable decline of the U.S. manufacturing sector, prompting the current U.S. administration to call for a revised agreement. The renegotiations, among other measures such as newly imposed U.S. tariffs, contribute to growing concerns about possible trade wars and the potential impact on U.S. and global economic growth. Critics of trade frameworks such as NAFTA commonly cite job losses and trade deficits as clear evidence of unfavorable trade policy. The global and complex nature of modern trade, however, requires that the policy costs and benefits be evaluated and understood beyond headline statistics through a variety of perspectives.

The decline in U.S. manufacturing employment over the past two decades has coincided with not only NAFTA's inception, but also advancements in technology and global supply chains (**Figure 1**). Higher productivity through automation and other efficiency gains meant that fewer workers were needed to create the same output. At the same time, the 1995 creation of the World Trade Organization (WTO) enabled companies to shift production to countries with a surplus of low-cost labor. In assessing the relative impact of these two forces, technology is estimated to have accounted for up to 87% of U.S. manufacturing job losses from 2000 to 2010, while the remaining 750,000 jobs lost can be tied

Figure 1. Gains in productivity are the key driver of fewer U.S. manufacturing jobs



Note: Data cover January 1, 1990, through October 1, 2017.

Sources: Vanguard analysis, using data from the World Trade Organization, the Organization for Economic Co-operation and Development (OECD), the U.S. Bureau of Labor Statistics, and the U.S. Census Bureau.

to the growth in imports.[1] Within that trade-related portion, other studies have attributed many of the job losses to substantial import growth from China.[2]

Given that much of the labor supply increase occurred outside North America, it is likely that NAFTA preserved jobs within the region by fostering economic integration in key industries such as machinery, automotive, and energy. By encouraging companies to "nearshore" rather than offshore, NAFTA created a competitive alternative to growing manufacturing centers in Asia and Eastern Europe. This is apparent even in the commonly cited U.S. trade deficits with Canada and Mexico **(Figure 2)**. Although the NAFTA members constitute nearly 25% of U.S. trade, the United States has a slight surplus with its two neighbors, after accounting for services trade and the origin of value added.[3] A closer look at the composition of North American trade reveals more benefits for particular geographies and sectors than simple aggregate deficits suggest.

NAFTA's benefits are mixed among and within its member countries

NAFTA's success in preserving North America's global competitiveness is evident in an alternative measure of trade known as "trade in value added." Unlike traditional trade balances that measure the absolute flow of imports and exports between two countries, "trade in value added" accounts for the complexity of global supply chains by identifying and tracking where and how much value was contributed during the production process as it crosses borders. For example, a car imported into the United States from Mexico and assembled with Japanese parts will be reflected in the U.S. as imports from both Mexico and Japan, rather than just Mexico.

Amid the rapid globalization over the last two decades, the NAFTA region retained its share of U.S. imports much more effectively than did other U.S. trading partners from 1995 to 2011—a period when U.S. imports nearly tripled **(Figure 3)**. Looking at U.S. imports based on the origin of value added, the NAFTA zone's share declined by about 1.6 percentage points, compared with 3.4 percentage points for the European Union and 11 percentage points for Japan. In aggregate, rather than exacerbating U.S. manufacturing job losses, the preferential trade terms shared by the United States, Canada, and Mexico helped the region retain its economic relevance in the global marketplace.

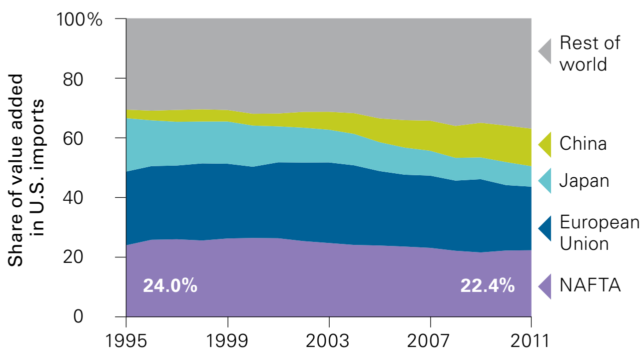
At NAFTA's inception, each country expected a shift of lower-wage, lower-skill jobs from Canada and the United States to Mexico, while Canadian and U.S. employment would continue to move toward higher-paying skilled work in manufacturing and services. As trade and economic

Figure 2. Conventional trade deficits in goods exaggerate imbalances

Note: Data are as of 2016 (latest available annual totals).

Sources: Vanguard analysis, using data from the World Trade Organization, the OECD, the U.S. Bureau of Labor Statistics, and the U.S. Census Bureau.

Figure 3. North American trade has maintained its share of U.S. imports



Note: Data cover 1995 to 2011.

Sources: Vanguard analysis, using data from the OECD-WTO Trade in Value Added (TiVA) database.

1 Hicks, Michael J., and Srikant Devaraj, April 2017. *The Myth and the Reality of Manufacturing in America.* Muncie, Ind.: Ball State University Center for Business and Economic Research.

2 Acemoglu, Daron, David Autor, David Dorn, Gordon H. Hanson, and Brendan Price, August 2014. *Import Competition and the Great U.S. Employment Sag of the 2000s.* Working Paper No. 20395. Cambridge, Mass.: National Bureau of Economic Research.

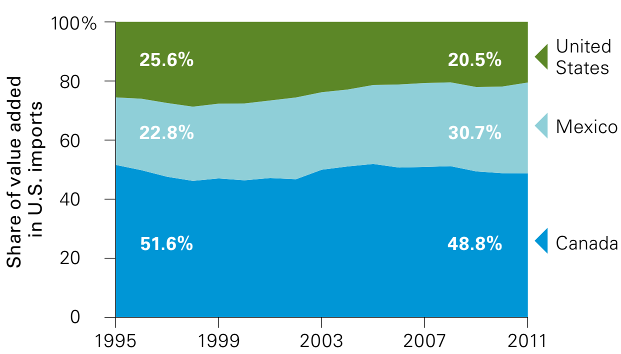
3 U.S. Census Bureau and U.S. Bureau of Economic Analysis news release, February 6, 2018. "U.S. International Trade in Goods and Services, December 2017."

activity increased, each country would experience incremental growth, with Mexico growing more quickly to converge with its neighbors' higher standards of living.

Looking at trade in value added within NAFTA, these shifts have occurred as expected at the country level. The proportion of value added has increased for Mexico, and decreased slightly for both Canada and the United States, as companies shifted toward lower-cost locations within the trade zone, such as to Mexico or the nonunionized U.S. South **(Figure 4)**. Despite this shift in value added in favor of Mexico, its manufacturing wages have not converged with wages in Canada or the U.S., and none of the countries experienced real wage growth in manufacturing above 20% from 1996 to 2015. This suggests that much of the gains from trade were focused in other industries or segments of the economy (for example, consumers of lower-priced durable goods).[4]

Even in certain manufacturing and resource sectors, gains in the balance of trade among the NAFTA members have been mixed **(Figure 5)**. In machinery trade, the balances that existed in 2001 are nearly unchanged today. In energy and minerals trade, the deficit with Canada increased, and the former deficit with Mexico is now a surplus. In automotive and aerospace trade, the deficit with Canada contracted to neutral, while the deficit with Mexico expanded by nearly the same degree. These three product sectors accounted for about 60% of total goods trade within the NAFTA zone in 2017, and they illustrate how different industries have shifted within the bloc to leverage each country's advantages. For example, automotive

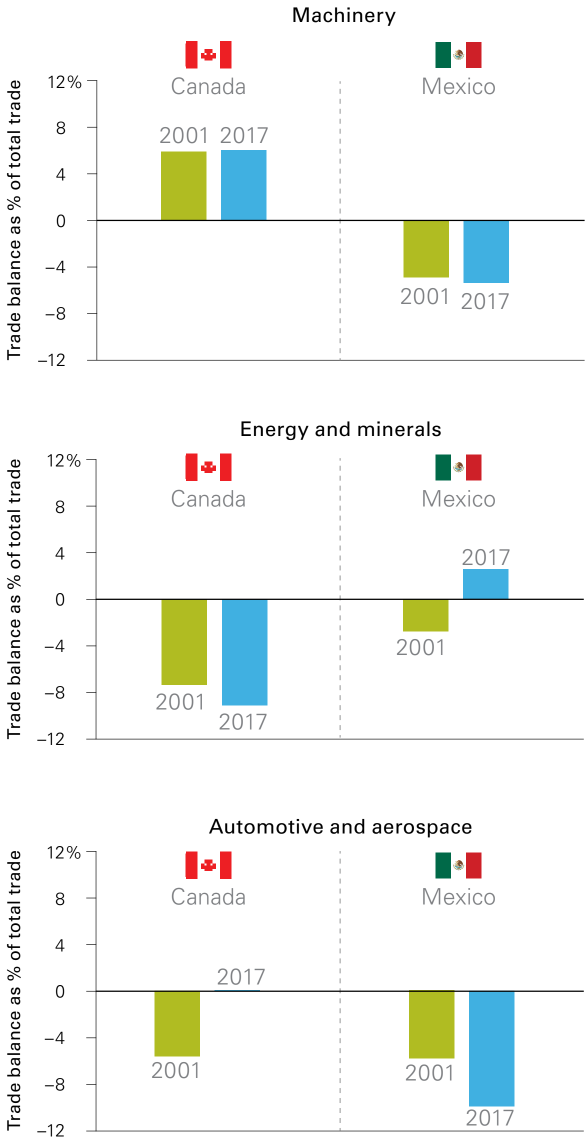
Figure 4. Mexico has expanded its share relative to Canada and the U.S.



Note: Data cover 1995 to 2011.

Sources: Vanguard analysis, using data from the OECD-WTO Trade in Value Added (TiVA) database.

Figure 5. Each country benefited in different industries



Sources: Vanguard analysis, using data from the International Trade Centre.

4 Sources: Vanguard analysis, using data from the Conference Board's International Labor Comparisons program and Thomson Reuters Datastrea

manufacturing shifted in favor of lower labor costs in Mexico, while Canada's oil and gas production expanded to contribute to the growth of refining and storage in the U.S. Certain communities tied to these industries in the region will inevitably benefit more than others.

A revised NAFTA may be delayed, but termination is unlikely

With the advent of the internet, mobile computing, and global supply chains, the region as a whole stands to benefit from a modernized framework that incorporates changes that reflect today's economic landscape. As part of this modernization, each country agrees on including additional anticorruption measures, broader industry coverage (for example, energy in Mexico and e-commerce), and updated labor and environmental standards in order to maintain and extend global competitiveness. Beyond these mutually beneficial terms, the Office of the U.S. Trade Representative has proposed revisions that specifically favor U.S. terms of trade, such as higher U.S. and regional content requirements (known as rules of origin) for cars built within the NAFTA region. The Trump administration's threat to withdraw from the agreement and temporary exemptions in steel and aluminum tariffs provide incentives for an agreement favorable to the U.S.

At this stage, delay and eventual compromise are the most likely outcomes **(Figure 6)**. The United States, having committed to achieving concessions and threatening withdrawal, will continue to negotiate to achieve some token successes among its proposals, such as a minor upward revision in the regional content requirement for autos. Termination of NAFTA is less likely than many expect because of the short-term disruption that would result for each member country—especially Mexico and Canada. This threat is ultimately not a legitimate option for the United States, given the harm it would cause the auto, energy, and agriculture industries and the legal uncertainty about whether a withdrawal by executive order would be approved by Congress and upheld by the judiciary. Even if the U.S. were to withdraw, currency fluctuations would absorb any short-term increase in trade costs, and reversion to WTO rules would maintain the structure necessary for the three countries to continue trading. It would, however, further damage global sentiment about the trajectory of U.S. trade policy.

The timing and features of a revised agreement remain uncertain. Because of elections taking place midyear in Mexico and this fall in the United States, negotiations after the eighth round in April might not resume until after December 1, when Mexico's presidential term begins. Such delays cause uncertainty for businesses looking to invest in the region and provide an impetus for negotiators to reach a compromise in the eighth round. Whether then or closer to early 2019, the most likely outcome is a modernized NAFTA that features some concessions to the U.S. proposals. These negotiations—along with other new trade measures—are likely to be a source of short-term market volatility, as discussed in **our recent article about tariffs and protectionism**.

As the comparisons by geography and sector show, trade agreements produce uneven benefits, but in aggregate they are positive for each country's economic fundamentals and the financial assets tied to them. Despite the contentious nature of the NAFTA negotiations, they remain an opportunity for the three countries to modernize their trade agreement at a critical juncture in globalization.

Figure 6. An eventual deal is the most likely outcome

	Compromise	Delay	Termination
	Parties agree to a modernized NAFTA 2.0, with only minor concessions to U.S. proposal	Negotiations extend beyond Q2 2018 as U.S. proposals are revised until a compromise is reached	Negotiations fail, with a six-month transition to WTO standards
Likelihood	40%	45%	15%
GDP	▲	—	▼
Inflation	—	—	▲
Employment	—	—	▼
Equities	▲	—	▼
Bond yields	▼	—	▲
U.S. dollar	▼	▲	▲

Sources: Vanguard estimates, based on analysis using the Federal Reserve Bank of New York FRB-US model.

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