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Global Trade

Nafta: First shots in a trade war

Trump's policies jeopardise a \$580bn relationship with the US's neighbour, but Mexico has a few cards to play in any talks

The Big Read



Enrique Peña Nieto, the president of Mexico, is urging the US not to go ahead with border taxes © FT montage

JANUARY 30, 2017 by: **Jude Webber**, **Shawn Donnan** and **John Paul Rathbone**

It could hardly be clearer: [Donald Trump](https://www.ft.com/donald-trump) (<https://www.ft.com/donald-trump>) is threatening to pull the trigger on a trade war with [Mexico](https://www.ft.com/topics/places/Mexico) (<https://www.ft.com/topics/places/Mexico>) that could blow apart a relationship worth \$1m a minute. The far-fetched prospect of better-than-ever bilateral ties, which the president invoked hours before torpedoing a summit with his counterpart Enrique Peña Nieto, now looks like a mirage.

Mr Trump's gambits include floating a unilateral 20 per cent tax on [Mexican imports](http://next.ft.com/content/a6ecf4e2-e3eb-11e6-8405-9e5580d6e5fb) (<http://next.ft.com/content/a6ecf4e2-e3eb-11e6-8405-9e5580d6e5fb>), humiliating Mexico by signing an executive order to start [construction of a border wall](http://next.ft.com/content/918ec1de-c8c3-3cc8-885f-1f2a2f61fodo) (<http://next.ft.com/content/918ec1de-c8c3-3cc8-885f-1f2a2f61fodo>) while its ministers were in Washington and telling Mr Peña Nieto it was pointless to hold the summit unless he agreed to pay for the barrier.

Despite an [hour-long call between the presidents \(http://next.ft.com/content/ff134eb4-e4c2-11e6-8405-9e5580d6e5fb\)](http://next.ft.com/content/ff134eb4-e4c2-11e6-8405-9e5580d6e5fb) on Friday, which seemed to have eased some of the acrimony, relations between the neighbours are more fraught than at any time in the past four decades. Nobel economics laureate Paul Krugman [tweeted \(https://twitter.com/paulkrugman/status/824741226444251136\)](https://twitter.com/paulkrugman/status/824741226444251136) last week that team Trump were acting like “spoiled children playing with loaded guns” amid fears that the dispute threatened the collapse of the North American Free Trade Agreement between the US, Mexico and Canada.

The tax move has an echo from the early 1970s when the Nixon administration imposed a 10 per cent import duty on Mexico. But the stakes are far higher today. A \$580bn bilateral relationship and millions of jobs are on the line on both sides of the border, the product of nearly a quarter of a century of free trade that has made the US and Mexico “not just neighbours, but roommates” as former Mexican congressman Agustín Barrios Gómez puts it.

“All assumptions about the relationship are in play,” says Duncan Wood, head of the Mexico Institute at the Wilson Center in Washington. “We can no longer assume things will stay the same or integration will continue to deepen. There is a very real risk that things will deteriorate very rapidly.”



Enrique Peña Nieto with Donald Trump during their pre-election meeting in Mexico City in August 2016 © AP

Border tales

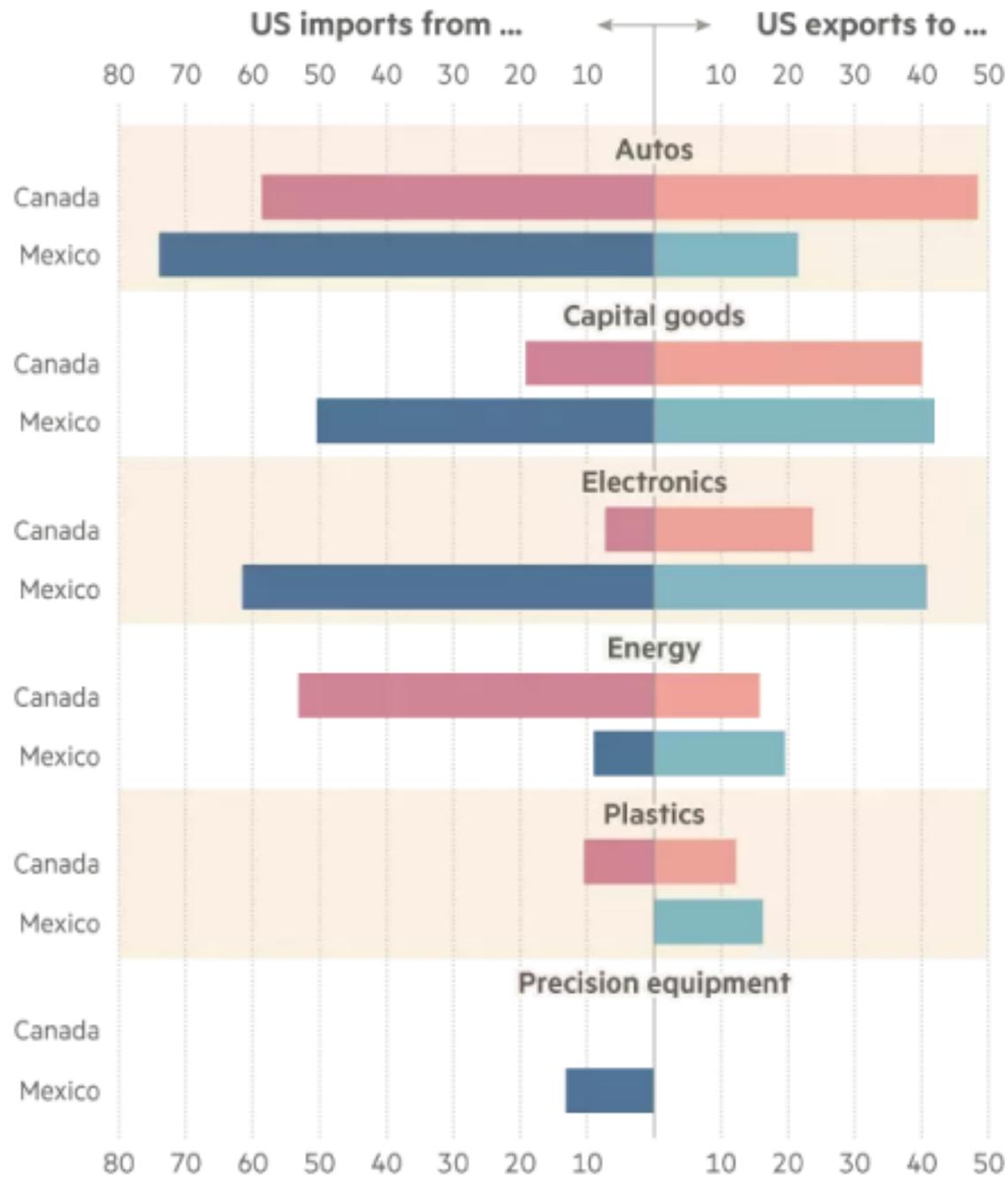
It is hard to quantify the damage to Mexico that killing Nafta would cause. Michael Camuñez, a former assistant US commerce secretary, calls it “the most dangerous moment of uncertainty in the bilateral relationship in the past 100 years”.

More than the millions of cars rolling off production lines every year — the motor industry has been one of Nafta’s big beneficiaries — the pact’s greatest gift to Mexico has been security for companies to do business. [US inflows \(https://fas.org/sgp/crs/row/RL32934.pdf\)](https://fas.org/sgp/crs/row/RL32934.pdf) to its southern neighbour, Mexico’s biggest source of foreign direct investment, have increased by more than six times to \$100bn since Nafta entered into force in 1994.

Nafta’s first year was one of escalating crisis for Mexico. The day it went into force, armed Zapatista rebels marched out of the jungles of the southern state of Chiapas and declared war on the state. Two prominent Mexican politicians were assassinated in the following months. By Christmas, a devastating currency crisis had erupted that threatened to push Mexico into default.

Active borders

Dec 2015–Nov 2016 (\$bn)



Source: Panjiva

FT

It might have been only a Mexican meltdown had the countries not just hitched their wagons to a deep and sweeping [trade integration](http://next.ft.com/content/47f25d54-98b4-11e3-a32f-00144feab7de) (<http://next.ft.com/content/47f25d54-98b4-11e3-a32f-00144feab7de>). “This is an American challenge,” declared President Bill Clinton, who rushed through a \$20bn bailout in early 1995. “The livelihoods of thousands and thousands of our workers depend upon continued strong export growth to Mexico.”

Two decades on, trade has soared. Commercial flows between the three partners hit \$1.1tn in the year to November 2016, according to data compiled by analytics company Panjiva. The value of the US trade in goods with Canada and Mexico is worth almost twice as much as its trade with China, even after the flood of cheap Chinese imports in recent years. It is worth almost 10 times as much as the [US trade with the UK \(http://next.ft.com/content/d70192aa-e251-11e6-8405-9e5580d6e5fb\)](http://next.ft.com/content/d70192aa-e251-11e6-8405-9e5580d6e5fb).

But Mr Trump seized on Nafta during the election campaign, blaming it for the death of [US manufacturing \(http://next.ft.com/content/eb6a3474-b095-11e6-a37c-f4a01f1b0fa1\)](http://next.ft.com/content/eb6a3474-b095-11e6-a37c-f4a01f1b0fa1) jobs. He exploited that to full effect in the rust-belt states and blue-collar communities that paid him back with their vote.

Wilbur Ross, the president's nominee for commerce secretary, told a Senate confirmation hearing this month that Mexico's low minimum wage would be "a very serious topic for conversation". He added: "One of the original intents [of Nafta] was . . . frankly [to] reduce the gap in productivity-adjusted wages between the two countries. It hasn't worked that way."



Border politics: undocumented migrants are detained at McAllen, Texas in 2015 © Getty

Salaries in the car industry are as much as six times lower south of the Rio Grande, something that has enabled a division of labour among the Nafta partners within the integrated supply chains that the trade pact has spawned. Components like seat belts and airbags cross the world's busiest border multiple times as they are transformed into finished goods, scrambling notions of

what is [Made in USA \(https://www.ftc.gov/tips-advice/business-center/guidance/complying-made-usa-standard\)](https://www.ftc.gov/tips-advice/business-center/guidance/complying-made-usa-standard), Hecho en Mexico or Made in Canada. Mexico exports 80 per cent of its goods to the US, but those exports contain 40 per cent US content.

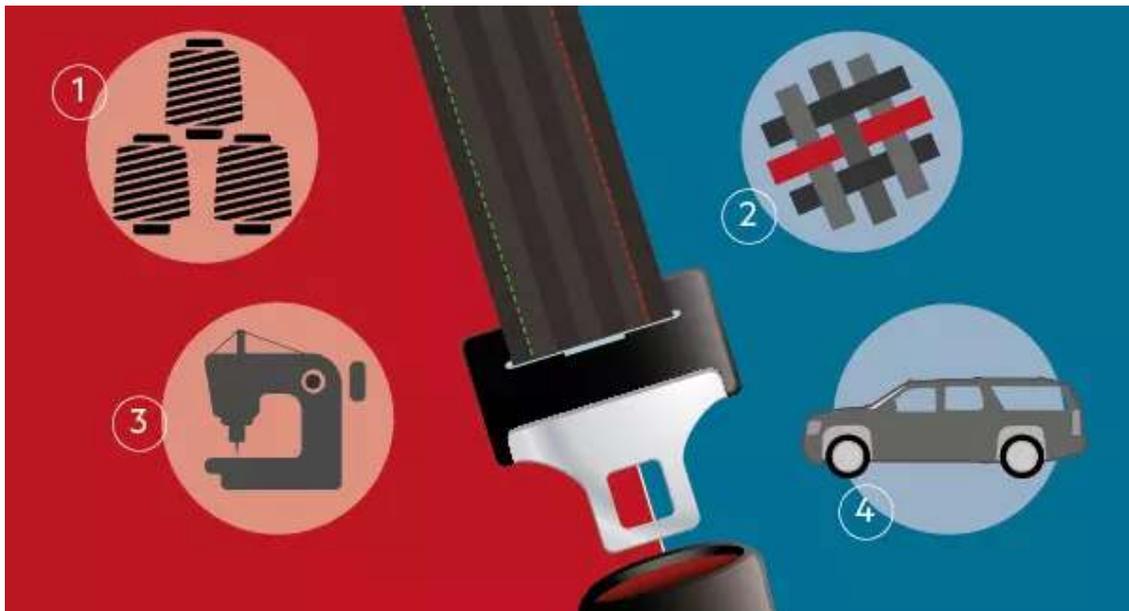
Mexican nylon for seat belts is exported to Canada to be woven and dyed and returned to Mexico for cutting, stitching and installing into vehicles that are then exported. Airbags are stitched in Mexico but tested in the US. Mr Trump has put pressure on US manufacturers since his election, via tweets and tax threats, not to shift production south. Ford [scrapped \(http://next.ft.com/content/b4bc7634-d1d9-11e6-9341-7393bb2e1b51\)](http://next.ft.com/content/b4bc7634-d1d9-11e6-9341-7393bb2e1b51) a \$1.6bn plant in San Luis Potosí, Fiat Chrysler says it may move pick-up truck production north and General Motors and Hyundai have announced big US investments.

Time running out

Despite the 5m US jobs that depend on commerce with Mexico in industries ranging from car parts to dairy products, the bilateral relationship goes well beyond trade. That is why Mr Peña Nieto is threatening to put everything on the table, especially if Mr Trump decides to pull the US out of Nafta or seek a renegotiation that Mexico deems unacceptable.

Mexico watches America's back on security, including via intelligence sharing. It is also a bulwark against Central American migrants. More than 43,000 families and 18,000 unaccompanied children from El Salvador, Guatemala and Honduras, were detained on the US-Mexican border in the last quarter of 2016 alone. Central Americans make up the second-biggest population of [undocumented migrants \(http://www.pewhispanic.org/2016/09/20/1-birth-regions-and-nations/\)](http://www.pewhispanic.org/2016/09/20/1-birth-regions-and-nations/) in the US after Mexicans, according to Pew Research Center.

A complicated supply chain



To create a seatbelt for a modern car:

The nylon fibres are manufactured in Mexico [1], but they are woven and dyed in Canada because the process requires a lot of water [2]. The cloth is cut and sewn in Mexico where labour is cheaper [3]. It is then fitted with other components such as buckles (also made in Mexico) and installed in either Mexico or the US [4]

It is, however, the \$60bn US trade deficit with Mexico that Mr Trump appears to see as an unbearable injustice and the reason for his vow to either negotiate a Nafta that is better for American workers, or walk away. “They’ve [Mexico] made us look foolish,” Mr Trump said last week.

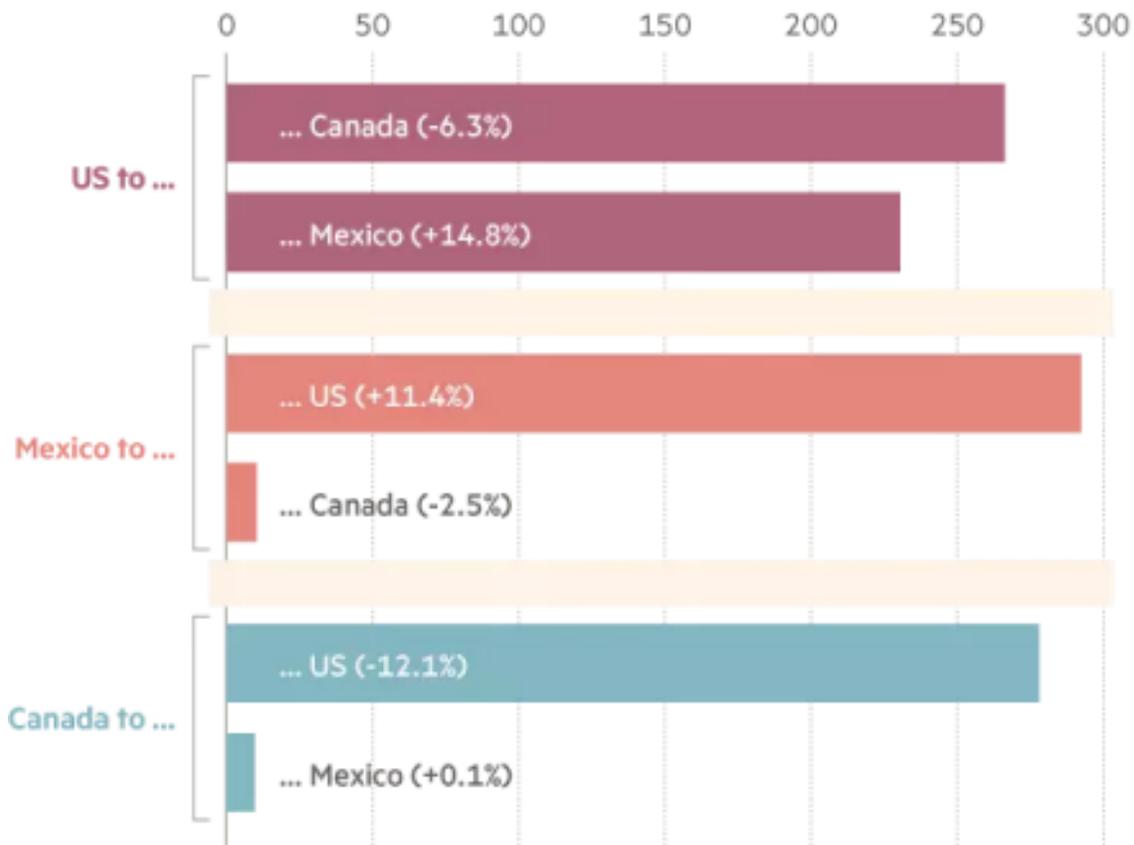
“The US deficit is \$700bn. Mexico is 8 per cent of that,” says Sergio Gómez Lora, a former member of Mexico’s Nafta negotiating team. “This deficit allows the US to be more competitive.”

No one has more riding on the outcome than Mr Peña Nieto. His approval ratings have been in freefall for two years amid corruption scandals, a slowing economy and mounting violence. The peso has sunk 13.5 per cent against the dollar since the US election. A 20 per cent [increase in petrol prices](http://next.ft.com/content/c8cad443-650f-38f6-ab0e-05fba0d19661) on New Year’s Day that helped propel inflation to an 18-year high this month saw his ratings slide to just 12 per cent amid a wave of protests.

Where the goods go

Exports, Dec 2015–Nov 2016, \$bn

(figures in brackets is % change from Jan–Dec 2011 to Dec 2015–Nov 2016)



Source: Panliva

FT

With more fuel price rises on the cards and the prospect of 1.5 per cent growth this year at best — and looming recession at worst — Mr Peña Nieto needs to display an ability to think on his feet unseen in his four years in office. Presidential elections, which maverick leftist Andrés Manuel López Obrador is tipped to win, are due in July 2018.

“I think Trump can win political points and not do economic damage by blustering and tweeting. But for Mexico, the economic pressures and the political realities are much more acute,” says Antonio Ortiz Mena, a former Mexican diplomat and part of the Nafta negotiating team. “[Mr Peña Nieto] basically has a year.”

Mr Peña Nieto is as non-confrontational as the US president is provocative, and his decision to scrap the White House trip in the face of the attacks from his US counterpart has galvanised support around him. But he cannot simply wrap himself in the flag and say Mexico will walk away rather than accept a bad deal — he needs a credible threat. That could take the form of

halting anti-narcotic, security and immigration co-operation or even revoking the visas of federal US employees in Mexico.

“It’s not as if Mexico goes away if we wall it off,” says Beto O’Rourke, a Democratic congressman from the Texan border town of El Paso, where one in four jobs relies on trade with Mexico. “At best, we push it into the arms of some other trading partners. At worst, we trigger a destabilising crisis. We really will have a problem if Mexico’s economy collapses.”

That would risk reviving the flow of Mexican migrants that dwindled to less than 900,000 in 2009-14 from nearly 3m in 1995-2000 and fuel crime and insecurity on the US’s doorstep. But playing nasty could prompt Mr Trump to target the annual [\\$26bn flow of remittances \(http://www.pewhispanic.org/2015/11/19/chapter-1-migration-flows-between-the-u-s-and-mexico-have-slowed-and-turned-toward-mexico/\)](http://www.pewhispanic.org/2015/11/19/chapter-1-migration-flows-between-the-u-s-and-mexico-have-slowed-and-turned-toward-mexico/) to Mexico.

Presidential gambit

Mr Trump has yet to put Nafta on the negotiating table formally, though he has vowed to renegotiate America’s trade deals and made clear they are one of his first targets. Among his incoming administration’s complaints have been the rules that govern how much of a product has to be made within Nafta borders to qualify as duty-free.



President Bill Clinton signs the Nafta trade agreement in December 1993 © AFP

The so-called rules of origin were a bone of contention for Mexico and parts of the US auto industry in negotiations for the 12-nation Trans-Pacific Partnership, from which Mr Trump has already withdrawn the US. But since Mexico was browbeaten by the US and Japan into accepting a weaker threshold, the issue is familiar to negotiators on both sides.

Some in Mexico and the US also see a shortcut to renegotiating Nafta in other aspects of the TPP, such as its chapters on ecommerce, labour and the environment. Rather than crippling Nafta, that actually could make it better, Mexico's government argues.

One possible spanner in the works is the Republican plan for tax reform, from which the idea for a levy of 20 per cent on imports is drawn. During the campaign, Mr Trump threatened to impose a 35 per cent tariff on companies that put factories in Mexico. But Republicans in Congress have been urging him to adopt their plan for broad tax reform, which targets imports and offers tax incentives to exporters.

Mr Trump is not the first US president to call for a renegotiation of Nafta — Barack Obama and Bill Clinton both did. Nor does Nafta guarantee harmony. Yet few in Mexico and Canada want to walk away. Nor do many in the US business community, where executives are hoping the dealmaker president will turn out to be a pragmatic businessman.

And Mexico may hold a trump card. "Mexico shouldn't worry too much," says Larry Rubin, head of the American Society of Mexico. "As Trump admits, Mexican negotiators are very good."

Car industry braced for tariffs and US pressure

No one is proposing building a wall in the middle of the Detroit river, but Donald Trump's advisers have put the global car industry on notice: Canada will not be exempt from punitive tariffs or strong-arm pressure.

Jerry Dias, head of Unifor, the Canadian autoworkers' union, says the result would be a "disaster" because of the deep integration between the industries on both sides of the northern border. He says a single automotive component may cross the border six or eight times before ending up in a car. Disentangling this supply chain could harm the industry on both sides of the border.

The Michigan-based Centre for Automotive Research says 31,000 US car and car parts jobs could be lost if the US pulls out of Nafta or imposes tariffs, but many thousands of

car industry jobs in Canada could be at risk too. The US Alliance of Automobile Manufacturers says 117,000 people are employed in vehicle manufacturing in Canada. Canada is even more dependent on exporting cars and parts than Mexico, according to CAR, which says Canada consumes only 12 per cent of the vehicles it makes and is also the largest market for US parts. The country exports twice the vehicles that it buys from the US. In 2015 it imported cars worth C\$26.6bn from the US and exported vehicles worth C\$54.6bn.

Ford, General Motors and Fiat Chrysler also recently committed to invest nearly \$1.6bn in the

Canadian car industry. Industry analysts say those investments could be at risk.

Mr Dias says he does not believe Mr Trump will target Canada. “It would be a disaster of course but I am not expecting it,” he says. “If the US wants to pick a trade war with Canada then we have a lot to say about it.”

Patti Waldmeir and Peter Campbell

This article was republished to correct a misspelling of Paul Krugman, the US economist

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