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THREE THINGS CEOS SHOULD DO NOW TO PREPARE FOR THE NEW NAFTA

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THE CORPORATE COMMUNITY IN the US, Canada, and Mexico is finally waking up from a long period of denial over the future of the North American Free Trade Agreement (NAFTA). In the fall of 2016, when politicians talked of renegotiating NAFTA, most business leaders dismissed it as campaign rhetoric. Six months ago, the common response was, "They'll tweak it and move on." Three months ago, the refrain was, "Let's wait and see what happens, and then we'll adjust." More recently, the line has been, "If NAFTA goes, we'll just fall back on the World Trade Organization's low tariff levels—we'll be fine."

But now, reality, and anxiety, are sinking in. Major changes in the 23-year-old agreement that governs more than $1 trillion in North American trade appear imminent. As the three countries move through their last two rounds of 2017 talks in Mexico City and Washington, DC, the differences in negotiating positions remain wide.

While it is too early to predict the magnitude of change to NAFTA, it is clear that trade within North America will be more restrictive, and the impact on businesses, industries, and entire economies could be substantial. The Trump administration is following through on one of the president's marquee campaign promises—to rewrite trade agreements in a bid to bring manufacturing and jobs back to the US. WTO tariffs, although higher than those under NAFTA, are not high enough to meet those objectives. Further restrictions from the US could therefore be expected.

Any business with goods, services, or people crossing borders within North America needs to prepare now. Business leaders should begin to assess the risk to their global value chains, work to influence policy, and develop a playbook for action based on several potential outcomes.

High Stakes for North America—and Beyond

The US, Mexico, and Canada are at an impasse over several key US demands. One involves tighter trade rules for the auto sec-

tor: for the first time, cars entering the US duty free would need to have high US content. Overall North American content requirements would also increase. In addition, the US wants a "sunset clause" limiting NAFTA to only five more years unless renewed by all three countries and the elimination of a trinational mechanism for mediating disputes. US president Donald Trump has stated that if his negotiators can't get a deal he likes, he will abrogate the agreement. At a press appearance in mid-October with the Canadian prime minister, Trump said that he has been "opposed to NAFTA for a long time….I think Justin understands that if we can't make a deal, it'll be terminated."

If NAFTA were rescinded, WTO trade rules would in theory be in force in North America. Tariffs would rise on 62% of the goods that the US imports from Mexico and Canada, on 52% of US exports to Canada, and on 72% of US exports to Mexico. The implications would be significant. A reversion to WTO tariff levels would reduce GDP by 0.12% in the US, 0.55% in Canada, and 0.71% in Mexico after one year, according to an analysis by Scotiabank. While the economic impact may appear to be modest, Scotiabank estimates that it would translate into as many as 100,000 lost jobs in Canada, up to 200,000 in the US, and up to 380,000 in Mexico.

But it's not clear if the US will stick to its WTO commitments. To take just one example, under the WTO rules, US tariffs on Mexican and Canadian passenger cars would be only 2.5%—a level unlikely to support the US goal of boosting domestic automotive manufacturing. By contrast, under WTO rules, tariffs on US-made passenger cars would rise to 5.8% in Canada and to 31% in Mexico. So there is reason to assume that much higher US tariffs would follow. It can also be assumed that Canada and Mexico would retaliate with tougher restrictions on US imports in product categories that are important to US politicians, such as agricultural products.

The stakes for all three economies are huge. Mexico exported $297 billion in goods to the US in 2016 and was a $231 billion export market for American producers. Canada imported $266 billion in US goods and services—more than $1 billion per business day. A major change in NAFTA would be felt in virtually every industry as companies reconfigure their value chains, logistics networks, and product-sourcing strategies. Manufacturers of automobiles, machinery, and consumer durables, along with agricultural producers, would be particularly affected. But the impact would also ripple through the transportation and logistics sectors, as well as services such as retail and finance.

Higher tariffs would also translate into higher retail prices for many products, which in turn could depress demand and prompt manufacturers to shift production from Mexico to low-cost nations in Asia, rather than the US. That would likely hurt US manufacturers that supply key components for goods assembled in Mexico and exported back to the US under NAFTA.

The drive to rewrite trade agreements hardly ends with NAFTA. Renegotiating NAFTA is part of a broader plan to remake the world trading system, an objective core to the Trump administration's worldview. Since the beginning of 2017, the US has taken action on trade arrangements involving countries representing some 80% of global GDP. The US has unilaterally withdrawn from the Trans-Pacific Partnership, suspended talks for a massive trade and investment deal with the European Union, reopened the US–South Korea trade agreement, and launched a sweeping action against China under US trade law. Even an agreement with six Central American countries that collectively represent only 0.3% of global GDP has been called into question.

More Losers Than Winners

As with any major policy change, rewriting global trade rules will create both winners and losers. In our work with clients, we have seen some companies that stand to benefit from increased US content requirements and from higher tariffs on products

that don't meet them. South American exporters of agricultural products will become more competitive in the Mexican market. And Asian manufacturers of such goods as large appliances will become more competitive in the US.

More often than not, however, we see risk to companies' cost bases and market channels from changes to NAFTA. In developing several scenarios for a manufacturing client, we found that if NAFTA were dissolved and existing WTO tariff rates applied, the financial impact for the manufacturer would essentially be zero because of preferential trade treatment for its product category. But the company's profits would be wiped out under a scenario in which tariffs on products that the company manufactures in Mexico climbed to the double digits and the costs could not be passed on to customers.

CEOs Cannot Wait and See

The risks and opportunities of changes to trade regimes should not be managed solely by legal or government affairs departments, or by operations units. They should be managed as fundamental strategic issues with direct CEO involvement. CEOs should think through not only defensive moves but also offensive ones that can secure competitive advantage. Preparing for the new NAFTA will also help companies be ready for other shocks to the global trading system.

We see three key steps that CEOs should take immediately:

- **Assess the value chain.** CEOs should oversee a bottom-up analysis of their companies' value chains, from manufacturing to retail, to identify risks from changes in trade policy. They should look carefully at distribution channels and end customers, as well as supplier bases, internal operations, and asset investments in each country where they operate. Companies should then assess their vulnerability to changes in revenue, costs, and asset utilization under a number of plausible trade scenarios. In addition to this inside-out perspective, CEOs should understand whether their competitors are more or less vulnerable to certain changes. Second-order effects must also be taken into account. If the US imposes trade restrictions on Mexico or Canada, for example, it should be assumed that those nations will retaliate. Such counter-measures, however, can often target unrelated sectors, chosen only to exert maximum pressure on US politicians who support trade restrictions.

- **Work to influence policy.** It is essential that company leaders communicate with government at all levels, everywhere the company operates, about how it will be affected by new trade rules in order to ensure that the company's interests are considered in the policy-making process. The company should seek allies among companies, community organizations, workers, and other stakeholders that benefit from its business. The company must also let customers, employees, suppliers, and shareholders know that it is prepared to survive and thrive in the face of changes in trade agreements.

- **Develop a response playbook.** CEOs should identify a set of actions to address risks and maintain their competitive advantage when trade policy changes. They should determine which actions can be taken right away under each trade scenario in order to gain speed and flexibility. Should companies change suppliers, their manufacturing footprint, and markets, for example? Leaders should identify the triggers that would prompt them to reconfigure their businesses under various scenarios, as well as potential offensive moves they can make to seize and secure competitive advantage.

What corporate leaders cannot afford to do is wait and see. NAFTA is changing. While we may not know to what degree, we know the direction. And when new rules come, their impact will be felt quickly. Companies that stay in front of the changes will be in the best position to move swiftly and decisively to protect their competitive position.

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