

# Research Briefing | US

## The cost of leaving NAFTA

### Economist

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**Unsurprisingly,  
NAFTA renegotiation  
is proving to be  
tough and slow**

**Table 1**

Scenario Analysis: NAFTA Withdrawal			
Level impact, 2019	US	Canada	Mexico
Real GDP	-0.5pp	-0.5pp	-0.9pp
Exports	-0.4pp	-0.3pp	-0.9pp
Imports	-0.6pp	-0.9pp	-0.8pp
FX rate (vs. USD)	---	-2.5%	-8%

Source: Oxford Economics

US withdrawal from NAFTA would cut the level of GDP in the US and Mexico by 0.5pp and 0.9pp, respectively, in 2019, with Canada taking a hit as well. A weaker Mexican peso and Canadian dollar would mitigate some of the damage to their respective economies.

- A unilateral US exit from NAFTA is a real possibility. Negotiations are slow and difficult, and the recent passage of the Tax Cuts and Jobs Act may embolden the administration to take a more protectionist approach in 2018.
- Our scenario modelling suggests that a US exit from NAFTA would reduce real US GDP growth by 0.5pp in 2019, while constraining growth in Mexico and Canada by 0.9pp and 0.5pp, respectively.
- The impact would lessen over time as supply chains would re-adjust to account for higher tariffs between the US, Mexico and Canada. By the end of 2022, the US output shock would diminish, but Mexico's GDP would be 2% smaller.
- A withdrawal from NAFTA would not significantly reduce the US trade deficit. The trade gap would remain at 3.2% of GDP in 2018 and 2019, compared with a modest widening to 3.3% of GDP in the baseline in 2019.

When the Trump administration officially [triggered](#) NAFTA renegotiation talks in May 2017, the hope was that a new trading framework could mutually benefit all three countries - Canada, Mexico and the US. All parties – not only the US – were open to reformulating and modernizing their trilateral trading relationship.

Several months into the renegotiation, the reality of rewriting NAFTA is proving to be much harder. Media reports indicate that while some advances have been made on the fringes, there has been little real progress on the core issues (including rules of origin, dispute resolution and sunset provisions). The fifth round of talks ended recently in a deadlock and the upcoming round of talks later this month in Montreal will be difficult. Worryingly, Canada and Mexico are taking an [increasingly hard-line approach](#) as they claim the US is largely unwilling to bend on its core objectives. Their earlier, more conciliatory, approach has not softened US demands. And, last week, we learned that Canadian officials are preparing for the [possibility](#) of a US withdrawal from NAFTA.

With the US administration looking to score a trade-related policy victory ahead of the US midterm elections and feeling emboldened by the recent fiscal policy win, it could decide to take a hard-line stance on NAFTA renegotiation. While our baseline forecast doesn't foresee an exit, we use the Oxford Economics Global Economic Model to quantify the possible implications of a unilateral US exit from NAFTA.

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**US terminating  
NAFTA cannot be  
completely  
discounted**

## US withdrawal from NAFTA: scenario assumptions

In our scenario, we assume that the three countries are unable to reach a new, conclusive agreement on NAFTA. The Trump administration, hoping to achieve its goal of narrowing the US trade deficit and return manufacturing jobs to the US, decides the best course of action is to end US participation in NAFTA (worth noting, this is only one of several possible outcomes from the ongoing NAFTA talks). In June 2018, President Trump gives his Canadian and Mexican counterparts the required six-month's notice that the US will no longer participate in NAFTA, beginning in Q1 2019.

With NAFTA no longer in force, the average tariff on US imports from Canada and Mexico would rise to 3.5%, in line with the WTO's "most favoured nation (MFN)" rules. Canada and Mexico meanwhile maintain free trade between each other (NAFTA would remain in effect between them even without the US), but the two countries' average tariff on imports from the US would rise to 4.2% and 7.4%, respectively (in line with the MFN rules). To be clear, in this scenario we do not explicitly account for the re-imposition non-tariff barriers that may occur if the US exits NAFTA.

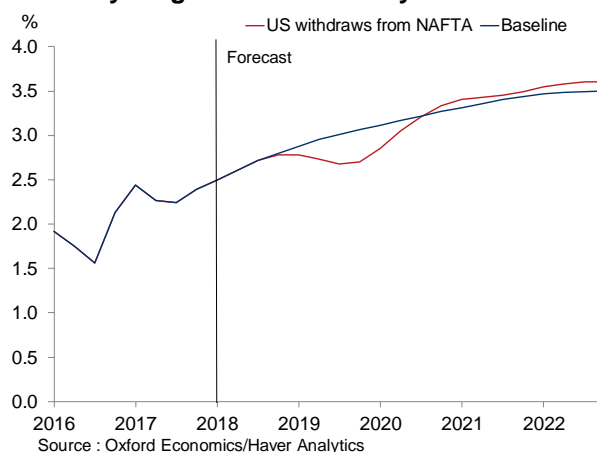
We assume that the respective average MFN tariff rate is applied across-the-board to all industries in each of the three countries. While we acknowledge that tariffs levied by each country would be determined on an industry-by-industry basis, using this framework allows the scenario modelling to remain fairly straightforward. Our scenario also assumes no punitive tariffs by any of the three countries. The aim of the scenario is to look at the implications of a "clean" US exit from NAFTA. Lastly, while President Trump has repeatedly called for a 35% import tariff, it's plausible the administration will reassure US [business leaders](#) by not raising the cost of imports significantly above MFN rates. Nonetheless, we assume the decision damages confidence and sparks financial stress as business, consumers and investors worry about the possibility of additional, more restrictive trade measures (the steel, aluminium and autos sectors would be potential targets).

The trade shock would be felt first in financial markets. After news of the US withdrawal, markets would become anxious about the implications of more protectionist US trade policy. Investors, fearing the ripple effects related to NAFTA withdrawal and less competitive US exports, would reduce their allocations of US equities. In this scenario, the S&P 500 would fall 5% below the baseline in early 2019. On the fixed income front, a flight into "safe haven" assets would cause long term interest rates to fall. The benchmark 10-year US Treasury yield would end 2019 at around 2.7% (compared to 3.1% in our baseline forecast). The US dollar meanwhile would appreciate mildly on a broad trade-weighted basis as strong appreciation against the peso and loonie would be partially offset by weakness against the euro and yen.

## NAFTA withdrawal would deliver a shock to financial markets

### Chart 2

US: 10-year government bond yield



The shock of US withdrawal from NAFTA would spark a "risk off" episode and a flight into safe haven assets.

**Prices would receive an initial jolt, and inflation would remain above the baseline through the end of our scenario in 2022.** North American supply chains would be disrupted as US businesses would likely source more materials and workers domestically – and at a higher cost – with that higher price then passed on to consumers (see Box 1). These pressures would be partially offset by a somewhat stronger trade-weighted US dollar which would mitigate the cost of more expensive imports.

**On the monetary policy front, despite higher inflationary pressures, our modelling indicates that downside risks to economic activity, would lead the Fed to shift into a dovish stance and cut interest rates.** Our scenario results indicate the federal funds rate would end 2019 at about 2.3%, compared to nearly 2.6% in our baseline.

**The shock of the US leaving NAFTA would transmit into the real economy, hobbling consumer spending and business investment in the short term.** The brunt of the shock would be felt in 2019, with real GDP growing a modest 1.5% (compared to growth of 2.0% in our baseline forecast). On the business front, the withdrawal would disrupt supply chains, and weigh on capital expenditures and employment (see Box 1). Our modelling shows that business investment would grow only 3.1% in 2019 (compared to 4.3% in our baseline) while the unemployment rate would average about 4.2%, compared to the 4.0% in our baseline. Meanwhile, on the household front, slower employment growth (the US would have about 300,000 fewer jobs by the end of 2019 as a result of the shock in this scenario compared to our baseline) and higher inflation would both weigh on real disposable income growth and consumer spending. Our scenario shows consumer outlays growing a modest 1.5% in 2019 versus growth of 2.0% in our baseline.

#### **Box 1: Understanding potential supply chain disruptions**

Since its implementation in 1994, businesses in Mexico, Canada and the US have utilized the free trading relationship provided by NAFTA to extensively integrate their supply chains. For example, 40% of US imports from Mexico and about 75% of US exports to Mexico are in [intermediate goods](#).

A withdrawal from NAFTA and the new, more costly trading environment would lead US firms to re-evaluate the benefits of their Mexican and Canadian operations. This would be a complex and drawn-out process and the outcome would differ at the sector and even company level (the degree of integration depends on the industry). The [two-way nature](#) of supply chains means that US withdrawal will hurt US exporters. Worth noting, some firms may maintain their current supply chain structure despite the higher trading costs, if relocating to the US is still comparatively disadvantageous.

**However, though the short-term downturn would be sharp, the long-term impact on the economy would likely be mild.** This is largely because the US is an insular economy with total trade (exports plus imports) representing only about 30% of GDP. For comparison, total trade represents about 80% and 60% of the Mexico and Canadian economies, respectively. To be sure, certain US industries (e.g. auto, manufacturing), with intertwined supply chains across the three countries, would surely [suffer](#). But beyond 2019, GDP growth would likely rebound above the baseline as supply chains complete their adjustment.

Further, more expensive imports from Canada and Mexico would likely lead some US firms to re-shore their operations, helping to partially offset some of the initial impact of the withdrawal. In the end, despite the short term drag on the economy, we don't believe a US exit from

**The real economy would feel the brunt of NAFTA withdrawal in 2019**

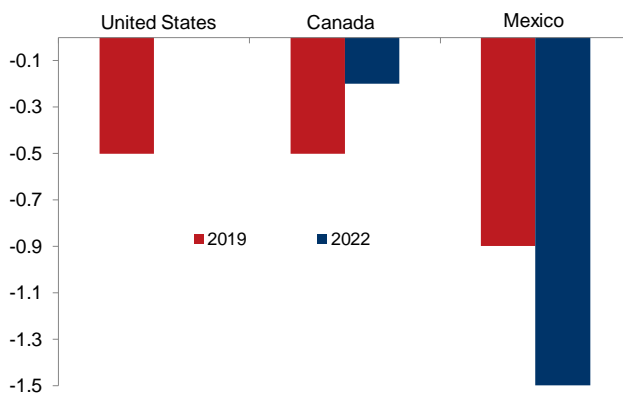
**NAFTA withdrawal would instigate a structural change in the economy...**

NAFTA would have a significant long-run impact on the economy's potential. The level of real GDP would revert to the baseline by 2022, benefitting in part from more accommodative monetary policy after the initial shock.

**Chart 3**

**NAFTA: Impact of US withdrawal**

Percentage point impact on level of GDP



Withdrawal from NAFTA would have a minimal long run impact on the US economy, but the impact on the trade-dependent Mexican economy would be significant.

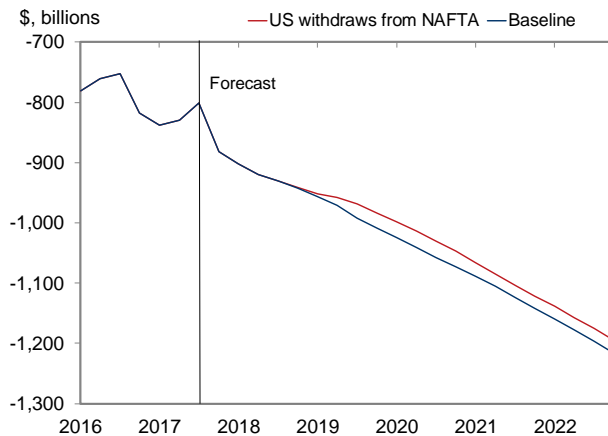
Source : Oxford Economics/Haver Analytics

**...but it wouldn't have a major impact on the trade deficit**

**Importantly, withdrawal from NAFTA would not significantly narrow the US trade deficit.** While leaving NAFTA would modestly trim the trade deficit, the reduction in imports would be largely offset by a concurrent loss in exports. In the end, the reversion to the WTO's MFN tariffs would still leave the Trump administration's goal of reducing the US trade deficit out of reach. The trade gap would remain at 3.2% of GDP in 2018 and 2019, compared with a modest widening to 3.3% of GDP in the baseline in 2019.

**Chart 4**

**US: Merchandise trade balance**



Leaving NAFTA would only have a marginal impact from the US trade deficit.

Source : Oxford Economics/Haver Analytics

**Mexico and Canada get hurt too**

**The trade shock would ripple through to Mexico and Canada, two trade-dependent economies.** Our results show Canada and Mexico suffering the brunt of the shock in 2019, with the level of GDP for these two economies about 0.5pp and 0.9pp lower, respectively, in our scenario compared to our baseline. Equity prices would fall as the business sector's prospects are imperilled, with Mexico's and Canada's benchmark stock indices lower by about 9% and 6% respectively on average in 2019 compared to our baseline.

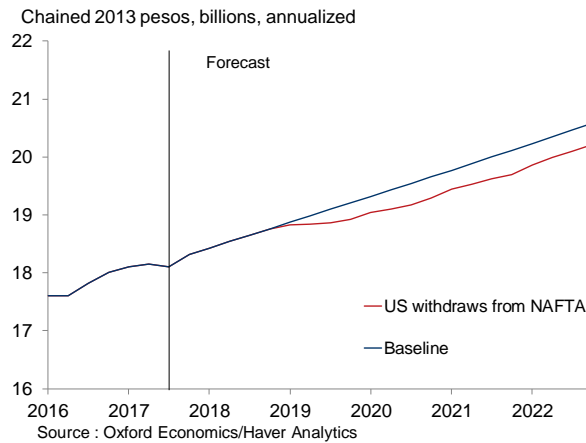
Partially mitigating the economic and financial market shock to Mexico and Canada would be a more competitive currency. The Mexican peso is seen to depreciate about 8% on average in

2019 compared to our baseline while the Canadian dollar is seen to fall about 3% on average in the same year.

A significant depreciation of the Mexican peso would also lead to stronger inflation, with CPI inflation 3pp higher than in the baseline in 2019, rising at an average pace of 5% y/y. This would have a significant negative impact on real incomes across the economy and constrain consumer spending and business investment.

**Chart 5**

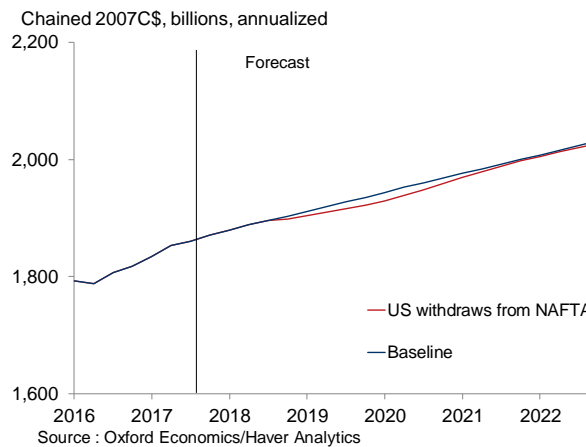
**Mexico: Real GDP level**



US withdrawal from NAFTA would reduce the size of the Mexican economy by 2% in 2022.

**Chart 6**

**Canada: Real GDP level**



Canada's economy would be about 0.5% smaller in 2019. The drag from the shock would fade in the outer years. By 2022, the level of GDP would be only about 0.2% lower compared to our baseline.