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Thank you for the opportunity to speak to you today about NAFTA and its critical importance to the long-term success, productivity and competitiveness of the United States and California.

We are now at the conclusion of the second round of the NAFTA modernization talks, something that neither Mexico nor Canada requested and something that could potentially be very costly for North American economic efficiency. Since the implementation of NAFTA, the trade and investment relationship among its member countries has exploded, and has created one of the most integrated co-production platforms in the world. We don't just trade with one another, we make things together, and in the process have created deeply integrated supply chains. The economic well-being of the United States and California depends on preserving NAFTA.

Yet the NAFTA renegotiation also presents **a great opportunity to update a 23 year old treaty**.

The North American Free Trade Agreement was signed in an era before there was ecommerce and social media; today ecommerce and social media are ubiquitous in our lives. NAFTA was signed in an era when the Mexican energy sector remained a monopoly of the state, the banking system had just been privatized following the 1982 nationalization, and the newly privatized Telmex enjoyed a government-protected telecommunications monopoly. Today, economic reform has opened the Mexican energy sector to private investment, domestic and foreign and the banking and telecom sectors to foreign investment and competition. Twenty-three years ago, Nafta's labor and environmental side agreements were the first of their kind and state of the art; today they show their age. And after 23 years we are still dealing with a lack of regulatory convergence and weak border infrastructure that undermine North American competitiveness.

So there is much that can be improved. There is also political pressure to make changes to the agreement.

Since 1993 **NAFTA has been the scapegoat for job losses in the US manufacturing sector**. It seemed inevitable that a free trade treaty between a low wage economy and a high wage economy would cause jobs to flow south, toward lower wages. And, of course, some of this did take place. But NAFTA was not the main reason the U.S. manufacturing sector hemorrhaged jobs during the past two decades. The main culprit was the rise of robotics and other labor-saving technologies. According to a study by the Center for Business and Economic Research at Ball State University, fully 85% of the 5.6 million jobs lost to the US economy in the first decade of the 21^{st} century was caused by technological change, not free trade. And of the jobs lost to free trade, the vast majority of these were caused by China's 2001 entry into the World Trade Organization, not NAFTA.

But for those who lost jobs, the most tangible *apparent* culprit was Mexico and its low wages. For 23 years union leaders and politicians have blamed NAFTA for the job losses that have upended the traditional middle class lives of millions of Americans. An argument that is all the more believable because NAFTA did cause job losses.

Workers' frustration with their economic situation and fear of the future is thus long-standing, and it found voice in the campaign rhetoric of Donald J. Trump. This rhetoric confirmed workers' conviction that NAFTA was largely to blame for their situation. It branded NAFTA "the worst trade agreement in history" that must be completely rewritten or thrown out altogether. And Trump's rhetoric confirmed the beliefs of the 39% of Americans and fully 70% or Republicans who, according to the Pew Research Center, see NAFTA as having been bad for the United States.

President Trump's campaign promise to rewrite or withdraw from NAFTA, strongly supported by Republican voters, has raised serious concerns about the very survival of the trade agreement. This is disconcerting given that NAFTA has created cross-border production chains that have made North America a manufacturing powerhouse. Production of automobiles, for example, is fully tri-national, sending inputs back and forth across international borders 5-8 times in the production process. Thanks to these supply chains, the production of autos and trucks, of airplanes and televisions, and of medical devices has remained globally competitive.

Even more troubling was President Trump's near decision to withdraw from NAFTA on April 26. This was informed by a basic misunderstanding about the importance of the agreement, and of trade more broadly, to the US economy, as evidenced by the leaked transcript of his January call with Mexican President Enrique Pena Nieto. We dodged the bullet when business leaders, interest groups, and even President Pena Nieto and Prime Minister Trudeau contacted the White House to urge Trump to not withdraw. And when Agriculture Secretary Purdue illustrated to the President the overlap between regions that are important exporters of agricultural goods to Mexico and who thus would be hurt badly by a disruption in bilateral trade, and the regions that voted for Trump last November.

Yet last week Trump revived this threat to withdraw the United States from NAFTA in order to give Mexico and Canada an incentive to make the concessions required to make the agreement "fair" for the United States.

President Trump's rhetoric implies that Mexico and Canada are economic adversaries of the United States. Nothing could be further from the truth. **Canada and Mexico are essential economic partners of the United States.** Allow me to illustrate this with some numbers about US-Mexico trade.

The US and Mexico trade nearly $578 billion in goods and services each year; that's $1.6 billion in trade each and every day.

Mexico is the third largest market for US agricultural exports (Canada is the first), buying 79% of US fructose exports, 28% of US corn exports, 24% of beef and 23% of pork exports. Overall, Mexico is the number two export market of the United States, exports whose production supports 5 million US jobs according to the Mexico Institute of the Wilson Center.

Mexico is also the third largest supplier of imported goods and services to the United States (Canada is again first), and our number one source of imported agricultural goods. Mexico is the first or second export market for 28 US states. And putting Canada back in the equation, and for 43 US states, either Mexico or Canada is their number one export market.

A similar story can be told about California's trade with Mexico. California traded $71.6 billion in goods and services with Mexico last year, exporting $25.2 billion and importing $46.4 billion. Mexico is California's number one foreign market, taking 15.4% of our exports last year and accounting for an estimated 550,000 jobs in the golden state.

And while the US trade deficit with Mexico has never been larger, it accounts for a mere 8% of the global US trade deficit. And, although I am sure you have all heard this before, it bears repeating: fully 40 cents of every dollar of goods Mexico exports to the United States is US content, content that is Made in the USA and exported to Mexico to be incorporated into products Mexico exports to the United States. In other words, 40% of every Mexican export to the United States is a source of good American jobs.

No other country in the world can say this because no other economy, with the possible exception of Canada, is as tightly integrated with the US economy as Mexico. For Canada the same figure is 25%; for China it's just 4%. And, according to the Manufactures Alliance for Productivity, if this US value-added in Mexico exports to the United States is included in the trade numbers the US actually has a trade surplus with Mexico.

All of this reflects the largely complementarity nature of our two economies, and there is perhaps no sector where the complementarity of our two economies is more apparent than in Agriculture. While there IS direct competition in some areas, such as Florida's winter tomatoes and sugar, for the most part, we do not compete with Mexico but engage in a symbiotic trading relationship. In most cases, either the product mix of our agricultural exports is different – where we export apples, almonds and wheat while Mexico exports fresh fruits and vegetables – or our different growing seasons allow consumers in both countries to have year-round access to a wider variety of healthy foods than in the past.

If this is what is at stake in the current negotiations to modernize the North American Free Trade Agreement, **what then is the status of these negotiations?**

The United States came out swinging on the first day of the negotiations. US Trade Representative Lighthizer's August 16 introductory comments briefly noted the areas where there is consensus on the need to modernize NAFTA – digital, services, ecommerce, Intellectual Property, energy and science-based agricultural trade. But he then insisted that NAFTA needs to be substantially restructured to benefit of the "countless Americans" for whom the agreement has failed.

NAFTA, he argued, required much more than a "tweak" to meet the concerns of the U.S. government. It instead requires "major improvement" to end the US trade deficit with Mexico, and an average annual deficit with Canada over the last decade. This would rely on revising NAFTA's dispute resolution mechanisms, modifying rules of origin to increase North American content in regionally produced goods and substantially increase US content, and making labor standards as strong as possible.

Most of these U.S. demands are of questionable value. Most economists agree that in a world of open global trade, the US trade deficits with Mexico and Canada are unimportant, as are all bilateral trade deficits. It is like saying an individual consumer has a trade deficit with his barber…it doesn't make much sense. As the Wall Street Journal editorial page noted in late August, Lighthizer's "obsession with Nafta trade deficits" is "bizarre economics" and is "dangerous to American prosperity".

The US demand that NAFTA's dispute resolution chapter, Chapter 19, be eliminated entirely and its Investor-State Dispute Settlement mechanism be revised is staunchly opposed by the US business community. And the Canadians have said they will never accept an agreement that eliminates Chapter 19. The US demand that regional manufacturing content, and specifically US content, be increased to receive duty-free treatment is also strongly opposed by US manufacturers, especially automakers, and by the Mexicans. This aggressive US stance is a clear sign that tough negotiations lie ahead.

So it is significant to note what Lighthizer did not say. Reflecting the USTR's July letter to congress laying out the US objectives for these negotiations, Lighthizer made no mention of raising tariffs as promised by candidate Trump. Such a demand would have turned the very logic of NAFTA – a FREE trade area – on its head, and would have ended the negotiations before they even started. Mexico has repeatedly insisted that any mention of tariffs or quotas would cause it to withdraw from the negotiations.

In their opening statements as the start of the NAFTA modernization talks, the heads of the Mexican and Canadian delegations took a much more diplomatic approach emphasizing the need to protect the benefits NAFTA has provided the region. Mexican economy secretary Ildefonso Guajardo pointedly quoted Lighthizer's Congressional testimony in which he promised to "first do no harm" to the agreement.

The first round of the negotiations reflected this offensive US posture and Canada and Mexico's defensive stance. It also reflected the ambitious time frame within which the delegations plan to complete the negotiations, and their sharply different perceptions of the core objectives of the negotiations.

During the first round the United States is reported to have formally presented the text for 10-14 of an expected 25-30 chapters of the revised agreement, a striking number when a typical first round of a trade negotiation is devoted largely to logistics. Tabling this amount of text shows that the United States is in as much as a hurry to complete these negotiations as is Mexico. Neither country wants the negotiations to get caught up in electoral politics surrounding the July 1 Mexican presidential election and the November 7 US congressional election. The US delegation also has keep in mind the July 2018 expiration of the Administration's fast track authority.

Finally, the joint communique issued by the three parties at the end of the first round of negotiations signaled that the parties are far from finding the common ground needed to reach an agreement. The US wanted to refer to the process as a *renegotiation* of NAFTA while Mexico and Canada call it a *modernization*. The joint communique papered over this disagreement by referring to both a renegotiation and a modernization of the existing agreement.

Between the first and second round, President Trump dialed up the tension surrounding the negotiations by insisting repeatedly – in his August 22nd Phoenix speech, in a series of August 27th tweets, and at a news conference the next day – that he may initiate the US withdrawal from NAFTA to pressure Mexico and Canada to make the concessions his negotiators are demanding. While both the Mexicans and the Canadians responded diplomatically, the Mexican economy minister made it clear that Mexico would walk away from the negotiations if Trump took such an action and estimated that the probability of a US withdrawal was "real and high".

It is also unclear if the US president has the constitutional authority to pull the country out of NAFTA. What is clear is that business groups have promised to challenge the president if he takes such action. All of which suggests this threat is likely a negotiating tactic designed to strengthen the US hand in the talks.

Still, these threats coupled with US demands raised then tension at the outset of the second round. Given this, the United States chose not to table any controversial chapters such as rules of origin and dispute resolution in the second round for fear of derailing the negotiations. While controversial issues were discussed, only the formal text for several non-controversial chapters was introduced, said to include small business, competitiveness, digital trade, services and the environment. No chapter text, however, was formally accepted during the second round of negotiations.

The US Administration currently plans to table text for the three most controversial chapters – rules of origin, dispute resolution, and labor – during round three September 23-27 in Canada.

Allow me to briefly elaborate on several specific issues of particular interest to you. The area of energy has yet to be discussed because the negotiators have not decided if it will have its own chapter or if it will be dealt with as an issue that cuts across other chapters. Overall, there seems to be agreement among the three parties to do no harm while looking for ways to enshrine the Mexican energy reform in this NAFTA chapter.

In e-commerce, the United States presented text in the first round to raise Mexican and Canadian duty-free import limits to the U.S. level of $800 (from $50 and $20 respectively) which generated strong push back. I suspect the parties will find a middle ground on this most contentious element of the e-commerce chapter. In agriculture, the United States is considering a proposal that would allow southeastern US growers to bring anti-dumping and countervailing duty cases as a domestic region using seasonal rather than annual data.

Rules of origin and intellectual property are much more contentious issues. Regarding rules of origin, the United States used the second round of the NAFTA renegotiation to suggest a US content requirement of 30%-50% for automobiles, and a regional requirement of 70%-80%. These numbers were not formally presented in text, so it is unclear how wedded the US delegation is to them. Some analysts believe there is flexibility while others argue that Robert Lighthizer truly believes that these requirements will help bring manufacturing jobs back to the United States, something that the Mexican and Canadian negotiators, as well as most economists, dismiss as bad economics that could harm the competitiveness of North American supply manufacturing.

Regarding intellectual property, while this was discussed in the second round of negotiations this week in Mexico City, no text has been presented yet so the US position in many areas, including copyright, is still unknown.

What does this mean about the likely outcome of the NAFTA renegotiation? My sense is that sanity will prevail. NAFTA is just too important to the US economy, to US Agriculture, and to US manufacturing, for the United States to actually withdraw. And the benefits from modernizing the agreement are too great to let this opportunity go to waste.

Lighthizer's opening statement and first round demands, and President Trump's public threats, are likely an effort to establish an extreme position at the outset of the negotiation in order to arrive at a compromise close to the Administration's preferences. The fact that Donald J. Trump repeatedly used this negotiating tactic in his business dealings before arriving to the White House strengthens this conclusion.

Taking the US demand to eliminate Chapter 19 as an example, US negotiators understand that Canada is serious when it says it will accept no agreement without Chapter 19. They also know that any change to the dispute resolution mechanism would have to be presented to Congress 180 days before the signing of a new NAFTA, a bureaucratic step required by the Trade Promotion Authority legislation. This would deal a death blow to the expedited timeline the US has laid out for completing the negotiations. So this is unlikely to be a non-negotiable position.

The negotiations will inevitably be hard-nosed, but I believe they will ultimately bring us to an agreement that modernizes NAFTA in the areas of ecommerce, digital, IP, energy, services, and science-based agricultural trade, and modifies but does not radically alter rules of origin, government procurement, dispute settlement and labor and environmental protection.

Under this most-likely scenario, potentially the greatest challenge facing NAFTA modernization would be obtaining U.S. Congressional approval for a signed agreement.

While this is the most likely outcome and should be our objective, two wild cards remain: President Trump's penchant for throwing red meat to his political base, his need for a tangible win he can sell to American public, and Robert Lighthizer's conviction that multinational dispute resolution boards undermine US sovereignty. Any of these could derail the negotiations.

As Fred Bergsten of the Peterson Institute for International Economics in Washington recently noted, "Failure is clearly a US option." It is thus incumbent on Mexico, Canada, and the business community to show the US government why this would a big mistake for the United States.

In the absence of NAFTA, American exporters are apt to face higher tariffs and greater uncertainty, especially if they export to Mexico. Without NAFTA, zero tariffs will end and each country will revert to the World Trade Organization rates. Under their agreements with the WTO, the maximum tariff the US can impose on imports averages 4%, and for most goods it is 2.5%. For Mexico the average is 35%, and for agricultural goods it is 20%. This is not to say that Mexico will raise its tariff rates significantly, but it can. And Mexican presidential candidate Andres Manuel Lopez Obrador has promised to use all international trade tools available to him to reduce the flow of US agricultural exports to Mexico to encourage greater Mexican production.

Sectors that rely on cross-border production chains will need to adapt production to higher tariff rates crossing among the NAFTA economies. This *could* bring production back to the United States from Mexico. But it also could encourage production to move to Mexico to evade a high Mexican import tariff. Or it could encourage production to move from the United States to Canada, since after a US withdrawal the agreement would remain in force between the two remaining partners.

Cross border production chains are so strong and engrained it seems likely they will survive a US withdrawal from NAFTA. The US withdrawal from NAFTA would not mean the end to commercial relations between the United States and Mexico and Canada. It does mean relations will become more complex and less efficient, and that they will go through a period of uncertainty and adjustment.

Nor are trade relations the only area where a withdrawal from NAFTA would be felt. It would also significantly undermine Mexican confidence in the US as a reliable international partner. This would inevitably bleed over into other areas of the bilateral relationship that are of great concern to the United States, including Mexican cooperation in migration, drug-trafficking, and potentially even in confronting international terrorism.

This unpleasant scenario is obviously not where I think we are going, and it obviously is not my preferred outcome. But it is far from inconceivable, and should it occur it would be so disruptive for significant segments of the US and the California economies that we must prepare for it.