B | Global Economy and Development at BROOKINGS

POLICY BRIEF
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Developing a roadmap for USMCA success

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Introduction

The passage of the United States-Mexico-Canada Agreement (USMCA) through the U.S. Congress with overwhelming bipartisan support, as well as with strong political backing in Canada and Mexico, underscored the importance of USMCA for North American trade and economic relations.[1] It builds on the North American Free Trade Agreement (NAFTA) and largely retains NAFTA's commitment to lowering trade barriers although it rolls back trade openness in the auto sector. USMCA also adds new and robust commitments, particularly on digital trade, labor, and the environment.

The importance of USMCA for regional economic relations is amplified by growing geopolitical competition with China and the COVID-19 pandemic. This competition is over whether China will develop the world's largest and most innovative economy in this century with attendant military prowess, or whether the U.S., and the West more broadly, will retain its economic lead and dynamism. These tensions are leading to calls to reduce North America's economic reliance on China. The pandemic has also underscored the importance of expanding and deepening resilient supply chains, of which reshoring activities within North America will be vital to the region's economic health and sustainability.

USMCA presents an opportunity for the three countries—U.S., Mexico, and Canada—to "build back better" and leverage the region's collective talents, capital, and expertise to develop a more competitive, sustainable, and inclusive North American economy, which can rival some of its fiercest competitors. Ideally, USMCA will also provide a sustainable framework for the region to work as key partners on important and forward-looking issues.

At this critical juncture, the Global Economy and Development program at Brookings established the USMCA project to research, monitor, and support the development of an ambitious but achievable USMCA agenda. This work includes a website that will house interactive data on North American trade and investment flows, track USMCA committees and dispute settlement action, and follow compliance with USMCA commitments. It will also publish an annual report that will assess progress and identify opportunities.

Maximizing the opportunities that USMCA presents the region will require the three countries to see each other as true partners with a common cause. It would also be vital to develop a new narrative for the agreement that articulates both the economic and

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[1] Referred to as CUSMA in Canada and T-MEC (*Tratado entre México, Estados Unidos y Canadá*) in Mexico.

political importance of the USMCA for U.S., Mexico, and Canada relations. This view was widely shared by several participants at a recent Brookings roundtable—participants comprised of senior representatives from business, civil society, and former government officials from the three USMCA countries. The USMCA offers the framework for this strong partnership among the three countries.

This brief will provide background on NAFTA and how it has evolved into present day USMCA. It will then focus on five priority areas where progress is still needed and where USMCA could have the most impact:

1. Building a more competitive North American economy, including by growing trade and investment;
2. Ensuring resilient supply chains;
3. Expanding digital trade;
4. Supporting improvements in wages and working conditions; and
5. Addressing climate change.

The conclusion outlines some recommendations on how USMCA can help the region advance on each of these priority areas.

Building on NAFTA

NAFTA successfully led to significant growth in intra-block trade and investment, underpinned by growth in complex supply chains, and deepened cooperation on regulatory issues, including on the environment. Although there were some concerns over the impact of NAFTA on outsourced work to Mexico, evidence points to a small but positive net impact of NAFTA on jobs.[2,3] That said, there have been concentrated job losses in the U.S. due to trade, though this was mostly a result of rapid growth in trade with China.[4]

Figure 1 plots exports from the U.S., Mexico, and Canada to each other. The left panel presents nominal export values ($US billions), whereas the right panel presents the

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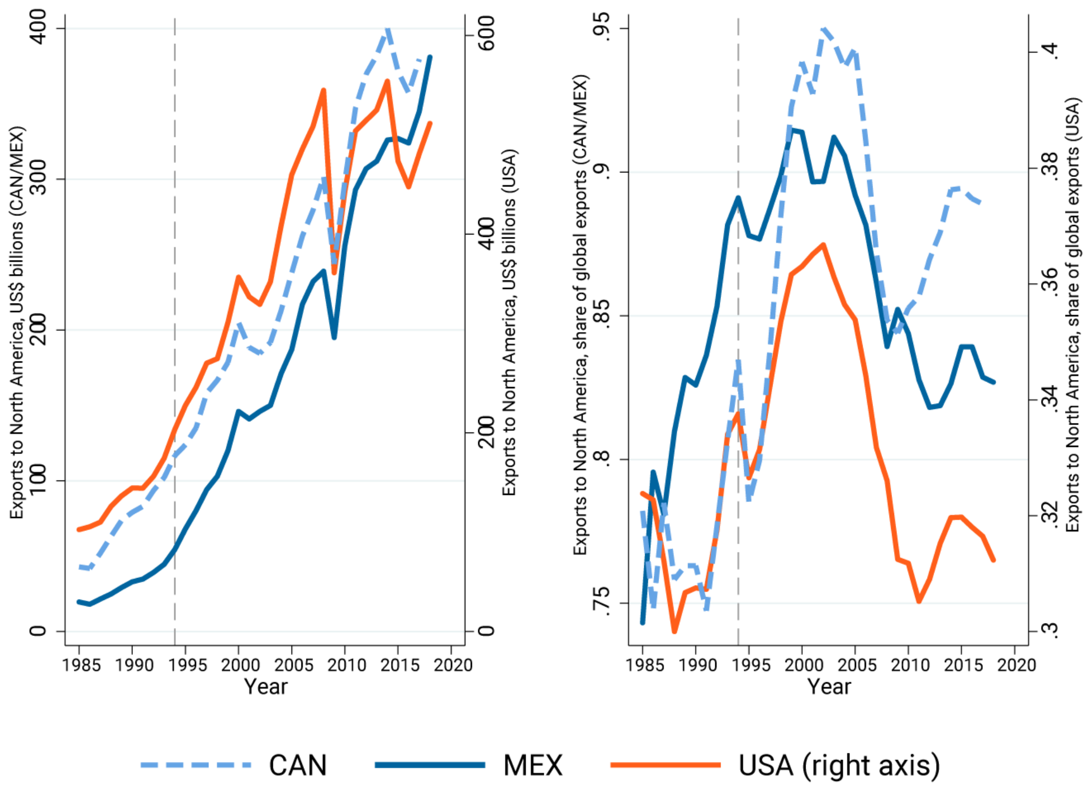
[2] Mauro F. Guillen 2017, "NAFTA created thousands of good American jobs – just not for Trump's Rust Belt Supporters".
[3] DeLong, J. Bradford. "NAFTA and Other Trade Deals Have Not Gutted American Manufacturing — Period." Vox, January 24, 2017. https://www.vox.com/the-big-idea/2017/1/24/14363148/trade-deals-nafta-wto-china-job-loss-trump.
[4] Rodrik, Dani. "What Did NAFTA Really Do?" Dani Rodrik's weblog. Accessed June 9, 2021. https://rodrik.typepad.com/dani_rodriks_weblog/2017/01/what-did-nafta-really-do.html.

same values as a share of each country's total exports (e.g., a value of 0.8 for Mexico implies that 80 percent of Mexico's exports go to either the U.S. or Canada).

FIGURE 1

USMCA Regional exports, nominal (left) and as a share of global trade (right)



Source: Atlas of Economic Complexity and authors' calculation

As can be seen in Figure 1, nominal exports within North America increased significantly over the past 25 years, and research shows that NAFTA was a key driver of this growth.[5] However, the right panel of the figure shows that while exports from each country to its North American partners increased after 1994 as a share of total exports, between 2000 and 2010—and following China's 2001 World Trade Organization (WTO) accession—there was a steady decline in the share of each country's intra-North American exports with some rebound following 2010. Figure 2 elaborates on this trend and further illustrates the significant growth in American, Mexican, and Canadian trade with China after 2001. For instance, between 2001-2018, U.S. exports to China increased over 400 percent to over 8 percent of total exports, and imports from China increased from around 7 percent to almost 20 percent of total imports. Canada and Mexico also

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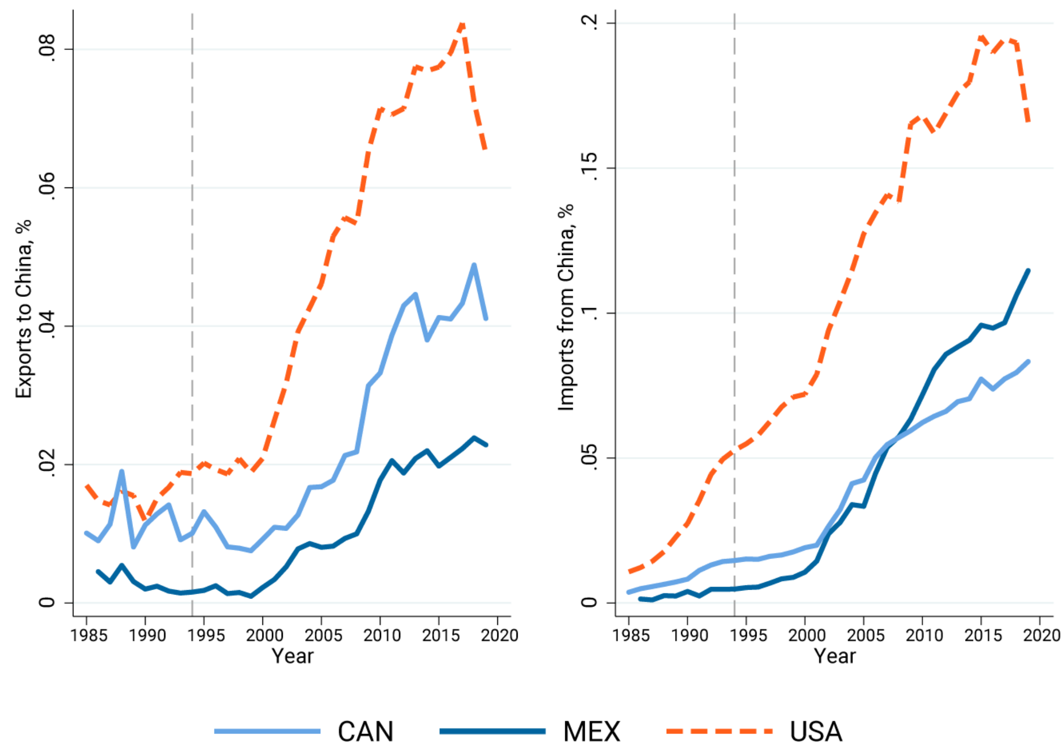
[5] Caliendo, Lorenzo and Fernando Parro, "Estimates of the Trade and Welfare Effects of NAFTA", *The Review of Economic Studies*, Volume 82, Issue 1, January 2015, Pages 1–44, https://doi.org/10.1093/restud/rdu035.

experienced large increases in trade with China during this period, though these countries' share of trade with China has been consistently lower than for the U.S. Mexico and Canada experience particularly large growth in imports from China—for instance, Mexico's imports increased from around 2 percent of total imports in 2001 to over 12 percent in 2020, reflecting in part the growing reliance on China as a source of intermediate goods uses in North American supply chains.[6]

FIGURE 2

Growth in U.S., Mexico, and Canada trade with China



Source: Atlas of Economic Complexity and authors' calculation.

As detailed later in the report, USMCA provides an opportunity to strengthen within-bloc supply chains, including reducing reliance on China for inputs and even reshoring some China-centric supply chains. Achieving this, however, will not be easy; North America will need to become a globally competitive place for manufacturing. This will involve balancing opportunities to compete with Chinese-centric supply chains while being open to trade with China, particularly where sourcing from China remains necessary for overall competitiveness.

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[6] Torsekar, Mihir (United States International Trade Commission). "Intermediate Goods Imports in Key U.S. Manufacturing Sectors." 2017.

From NAFTA to USMCA

USMCA is in many respects a continuation of the core NAFTA approach to trade with tariffs remaining at zero with some small improvements in market access particularly in the Canadian dairy, poultry, and egg markets. USMCA does, however, include important developments from the original agreement: There is some rolling back of trade liberalization, particularly when it comes to trade in automobiles. Auto Rules of Origin (ROOs) were increased from 62.5 to 75 percent, and in order to receive USMCA tariffs preferences, 70 percent of steel and aluminum used in automobiles must come from North America, and up to 40 percent of manufacturing costs for passenger vehicles come from plants with a minimum average wage of $16 per hour.[7] USMCA also includes binding obligations on labor and environmental matters that are subject to dispute settlement. In the case of labor, there is a new rapid response mechanism that allows each government to take action against facilities where certain labor standards are not met.

Other development from NAFTA include commitments on digital trade. USMCA also strengthens state-state dispute settlement, and limits Investor-State Dispute Settlement (ISDS) to dispute between the U.S. and Mexico over government contracts in infrastructure, oil and gas, power generation, telecommunications, and transportation. For disputes in other sectors, ISDS is limited to national treatment and direct expropriation claims, but only after local judicial remedies are exhausted or if the local process is found to be “obviously futile”. USMCA also includes a sunset clause under which USMCA will terminate in 16 years after its entry into force unless the parties agree to extend USMCA following a “joint review” by the parties in year 6 of the agreement.

Key policy changes from NAFTA to USMCA are outlined in the following table:

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[7] Average house wages in Mexico in 2000 were $8.11 (OECD)

TABLE 1

Policy changes from NAFTA to USMCA

Policy area	Major change from NAFTA
Agriculture	• Retains zero dairy tariffs • Canadian markets open to U.S. dairy, poultry, and eggs • U.S. markets open to Canadian dairy, peanuts, and sugar • Canada ends discriminatory grading for U.S. wheat • Modernized sanitary and phytosanitary measures • Cooperation on new biotechnologies
Automotive	• Increases labor value content (LVC) and regional value content (RVC) restrictions • Higher aluminum and steel requirements • New accumulation rules • Eliminates NAFTA RVC loopholes • Lowers administrative burden on manufacturers
Energy	• Zero tariff trade in energy products • Reflects 2013 Mexican energy reforms • Facilitates pipeline transfer of hydrocarbons • Flexible certification requirements for oil and gas
Environment	• More than $600 million to address environmental violations • Requires fulfillment of multilateral environmental agreement obligations • Introduces prohibitions against illegal fishing, overfishing, and overcapacity • Combats trafficking in wildlife, timber, and fish • Prohibits shark finning and the commercial killing of great whales • Agreement to reduce marine litter • Commitments are subject to USMCA dispute settlement
Industrial goods	• Higher RVC requirements for chemicals and steel • Agree to harmonize regulatory standards for medical devices to international best practices
Intellectual property	• Increased protection for industrial designs • Applies enforcement to the digital space • Introduces a system to deter piracy

	• Introduces strong due process requirements for GI protection
Investment	• More limited protections for investor-state disputes • Promotes cooperation to provide investment to SMEs
Labor	• Labor reforms and enhanced compliance obligations • Rapid response panels to engage facility violations in Mexico • Prohibitions on forced and child labor • Commitment by Mexico to recognize collective bargaining rights • Guarantee the secret ballot for union votes • Requires addressing (and threats of) violence against workers • Commitments are subject to USMCA dispute settlement
Services	• Liberalization of trade in services, but some uncertainty in certain sectors' market access
Digital trade	• Free flow of data • No data localization requirements • No access to source code • Prohibits customs duties on digital products • Facilitates easier digital transactions • Promotes cybersecurity cooperation • Protects again forced algorithm disclosures
Textiles	• Revised use of regional inputs • New flexibility in rules of origin
Trade facilitation	• Reduces border costs, especially for imports to Mexico • Tightens input tracking

In the U.S., these policy changes and improvements helped secure overwhelming bipartisan support in Congress; while NAFTA passed in the Senate with only 61-38 votes, USMCA gained much greater support with a margin of 89-10 votes. Similarly, in the House of Representatives, USMCA received 385-41 votes compared to a more divided House vote for NAFTA of 234-200. This presents an opportunity for a widely supported and bipartisan trade policy.

Setting a new agenda through USMCA

The agenda moving forward should build on the key elements in the USMCA that help generate broad political support and then identify the challenges and opportunities that can only be addressed through regional cooperation. The priorities are strengthening each country's global competitiveness (e.g., resilient supply chains); developing opportunities for digital trade; and ensuring the compatibility of international trade with labor and environmental standards. When setting the new agenda, governments need to consider the shifting global economic context such as rising nationalist politics, increased uncertainty over the ability of international trade to deliver broad-based social gains, and growing western tensions with China. In fact, USMCA currently reflects some of these trends. One example is an increased protectionist approach, particularly with respect to the auto industry. The USMCA also includes an option for the parties to leave the agreement if one enters into another free trade agreement (FTA) with a non-market economy—a way to prevent any of the participating governments from entering into an FTA with China.[8]

Looking ahead, an important inflection point is the six-year review of the agreement at which time the focus will be on whether the USMCA can deliver across all the important dimensions mentioned earlier, most likely with a focus on the impact on Mexican wages.

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[8] USMCA Article 32.10(1).

A roadmap for USMCA success

A little over one year into USMCA, we must look beyond the day-to-day market access issues and identify ways in which the agreement can become a framework for building a more competitive, sustainable, and inclusive North American economy. A successful agreement would maintain bipartisan political support and effectively respond to competition from China and other rising economies. There are five primary areas governments and relevant stakeholders must focus on to help achieve these objectives:

1) **Expand trade and investment to create a more competitive North American economy**: USMCA includes a range of commitments that can strengthen North American competitiveness by increasing within-bloc trade and investment that contributes to the overall competitiveness of the region, including in infrastructure and supply chains.

2) **Increase resilience and strength of North American supply chains:** COVID-19 underscored the importance of resiliency and proximity to consumers. Going forward, North America needs supply chains that are more resilient to short-term shocks, which in turn have the potential to make North America a competitive alternative to supply chains in China. USMCA can also support policies to increase human mobility in the region as well as investment in worker trainings, which will be crucial as complex supply chains become more knowledge intensive.

3) **Develop a digital North America:** USMCA includes a comprehensive digital trade chapter that can serve as the foundation for expanding digital trade opportunities across North America. Success here will also strengthen supply chains, create new opportunities for digital technologies such as artificial intelligence (AI), and make North America more inclusive by expanding access for small and medium enterprises (SMEs) to digital trade.

4) **Strengthen outcomes for labor:** It will be important to show that the USMCA labor chapter commitments are demonstrably effective. This will have two elements: First, proof of compliance by all governments—in particular by the Mexican government where the labor market contains many distortions —with agreements on labor commitments and second, successful use of the rapid response mechanism to address facility-level violations. Overall, USMCA should be successful where NAFTA was not: improvement in wage conditions and rates over time, though this must be paired with other non-trade related reforms to address low productivity growth in Mexico.

5) **Support ambitious climate change action:** Climate change will increasingly be the challenge through which all other economic policy tools are assessed. With the USMCA environment chapter and other commitments in the agreement, there is scope for North America to position itself as a leader in clean energy technology, discipline government action inconsistent with ambitious greenhouse gas reduction targets, and develop a coordinated approach to carbon border adjustment mechanisms.

As this brief outlines a range of priority areas for USMCA, it is also important to be realistic about what trade policy and USMCA can ultimately achieve. USMCA can help strengthen North American competitiveness, but to be truly effective USMCA needs complementary policies that increase investments in infrastructure and skills. For the USMCA labor commitments to have an impact on Mexico's wages, it will need to take into account other domestic drivers of Mexico's informal labor market, which affects aggregate wage rates and productivity levels.[9] This report, therefore, focuses on the areas where USMCA can make a meaningful difference and will identify the areas where additional complementary policies are needed.

1. Expand trade and investment to create a more competitive North American economy

The competitiveness of an economy depends on the conditions which confer unique advantages and disadvantages to firms operating in the economy. This includes a range of factors such as infrastructure quality, innovation potential, workforce skills, access to capital, functional judicial system, and long-term stability of government. For Mexico, the large informal sector means that labor and social insurance regulations are key drivers of Mexican wages and labor productivity.[10] Table 2 provides the ranking of the U.S., Mexico, and Canada among some of the 141 developed and developing countries ranked in the World Economic Forum (WEF) Global Competitiveness report. As seen in this table, there are big disparities between the U.S., Canada, and Mexico's rankings, the latter standing as the least competitive among the three. Southeast Asia and China are included in this table given the ambition to re-shore supply chains into North America where Mexico could become a low-cost alternative to some of the Asian countries ranked in the report.

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[9] Levy Algazi, Santiago, "Under-Rewarded Efforts: The Elusive Quest for Prosperity in Mexico", *Inter-American Development Bank,* July 2018.
[10] Ibid.

TABLE 2

WEF Global Competitiveness Index

Country	Rank
United States	2
Japan	6
Taiwan	12
South Korea	13
Canada	14
Malaysia	27
China	28
Thailand	40
Mexico	48

Source: World Economic Forum, Global Competitiveness Index 4.0 2019 Rankings.

If the past is any prediction about the future, free trade on its own is not enough to boost competitiveness. One of the main drivers of competitiveness is productivity: the ability of firms to produce more with the same resources (and hence at lower costs). Data from the Penn World Tables (v10) shows that by 2018 Mexico's total factor productivity levels were about 60 percent of the productivity in the U.S., down from about 85 percent in 1990 (see Figure 3). A similar pattern is seen for Canada, though much less dramatic in scope. Canada's productivity also diverged from that of the U.S. during the past decades, estimated to be today about 85 percent of the productivity in the U.S. However, it is important to note that the relative productivity decline stabilized for Canada and Mexico when NAFTA came into effect—until the global financial crisis in 2008. This does raise the question: Would these trends have been worse without NAFTA?

Mexico's overall poor productivity disguises significant differences between the country's export-orientated and more productive geographic north that is linked to the U.S. economy and the more traditional economy of southern Mexico.[11] The productivity difference between northern and southern Mexico highlights a larger set of economic challenges for Mexico. In order for Mexico to become more competitive, it needs a range of reforms to address structural issues, such as large informal markets functioning amidst deep market and institutional failures and distortions that prevent productivity growth.[12] Mexico also needs investments in infrastructure, expanded education opportunities, and a skilled workforce, particularly as supply chains become knowledge

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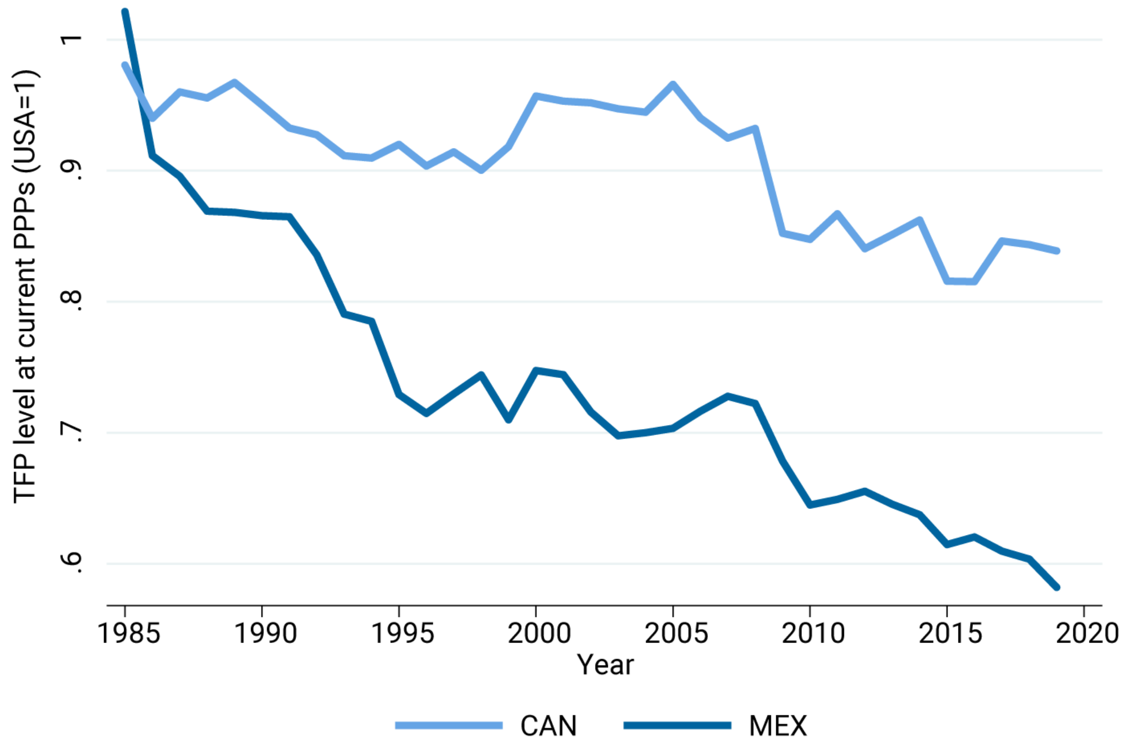
[11] Abhilasha Singh and Jesse Rogers, "Mexico's Productivity Puzzle: What the State Economies Can Tell Us", Moddy's Analytics, June 2017; Eduardo Bolio et al, "A tale of two Mexicos: Growth and prosperity in a two-speed economy", McKinsey Global Institute, March 2014.
[12] See Levy (2018) for a thorough discussion of the stylized facts of the Mexican economy with respect to productivity growth as well an analysis of the policy undertakings needed to fix many of these issues.

intensive and data and services play increasingly important roles.[13] Such an expansive competitiveness agenda is needed to extend the benefits of USMCA to underserviced regions like southern Mexico.[14]

FIGURE 3

Total factor productivity levels



Source: Penn World Tables (v10) and authors' calculation.

Drawing on Mexico's competitiveness needs, Table 3 outlines key areas where USMCA commitments can be used to help address current shortfalls.

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[13] McKinsey Global Institute, "Globalization in Transition: The Future of Trade and Value Chains", January 2019.
[14] Andrew Chatzky, James McBride and Mohammed Aly Sergie, "NAFTA and the USMCA: Weighing the Impact of North American Trade", Council on Foreign Relations, https://www.cfr.org/backgrounder/naftas-economic-impact.

TABLE 3

Role for USMCA for Mexico's competitiveness needs

Mexico's competitiveness needs	Role for USMCA
Expand access to finance for SMEs	• Use the SME Chapter to share information and best practices to increase SME access to finance • Focus SME Committee on expanding access to finance and utilize the multi-stakeholder SME Dialogue to keep updated on SME challenges
Strengthen governance in public institutions	• Ensure full implementation of USMCA • Use chapter on Good Regulatory Practices to strengthen governance process
Modernize and enforce labor laws	• Implement USMCA labor commitments
Improve training and education	• Expand cross-border education services
Incentivize long-term investment, including in infrastructure	• Ensure full implementation of USMCA to reduce Risk. Other particularly relevant USMCA chapters that can help reduce risk include, investment, macroeconomic policies, anticorruption, and good regulatory practices
Facilitate public-private partnerships	• USMCA government procurement chapter supports a transparent and competitive procurement process that can expand opportunities for public-private partnerships
Expand investment in research, innovation, and invention	• USMCA commitments on digital trade, services, and investment support data flows and the skills and investments needed to strengthen innovative capacity

Source: World Economic Forum, The Global Competitiveness Report Special Edition 2020.

As Table 3 shows, leaning into the broad range of its commitments, the USMCA has the potential to help address Mexico's competitiveness needs and barriers through its various committees and built-in dialogues.

The USMCA competitiveness committee provides an institutional focus for increasing competitiveness. While its scope and ambition are not yet determined, many of the constraints in all countries will be discussed. It is, therefore, important for the committee to develop a set of clear goals that are practical, achievable, and impactful.

Mexico is not the only country where USMCA can increase national competitiveness; Canada also lags in global competitiveness benchmarks. USMCA can support Canada by incentivizing public-private partnerships and supporting regulation of new technologies and greater regulatory coherence.[15]

USMCA could also help correct the failures of the Trump administration to lead on new trade deals in Asia, which has likely harmed U.S. competitiveness as tariffs were imposed on numerous intermediate goods. While the Trump administration spent several years pulling out of trade deals such as the CPTPP and raising tariffs on manufacturing inputs, the rest of the world concluded new trade deals, which lowered barriers and increased economic integration. This included the the EU-Japan and Canada-EU trade deals and Regional Comprehensive Economic Partnership, a regional trade deal in Asia. Against this context, USMCA can provide a North American framework for strengthening the capacity of the three countries—the U.S., Mexico, and Canada—to compete globally.

2. Increase resilience and strength of North American supply chains

North American trade is dominated by trade in intermediate goods and services used in supply chains. As Figure 4 shows, for Mexico and Canada, roughly half of those imports—from within the bloc—are intermediate goods, while for the U.S. about 60 percent of imports from Canada and Mexico are intermediate goods.

Given the importance of supply chains in regional trade, gross trade numbers fail to capture the extent of economic integrations and distribution of gains. For example, approximately 40 percent of Mexico's goods exports to the U.S. contain U.S. value-added.[16]

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[15] World Economic Forum, Global Competitiveness Report 2020 (December 16, 2020): pp. 45-46.
[16] OECD TiVA, https://www.oecd.org/sti/ind/measuring-trade-in-value-added.htm.

FIGURE 4

Trade between the U.S., Mexico, and Canada is dominated by intermediate goods

Source: OECD TiVA.

Growth in North American supply chains—alongside the information and communications technology (ICT) revolution—has been driven by NAFTA, which reduced trade barriers and provided assurance to businesses that tariffs and other trade restrictions would not increase. Lower tariffs are particularly important for supply chains where products cross borders multiple times during different stages of production.[17]

Supply chains can provide a number of benefits. For one, trade along supply chains is associated with greater gains as it allows for more specialized participation and exploitation of comparative advantage.[18] This is also true at the firm level where supply chains have been shown to deliver greater income gains and productivity growth.[19] The case for strengthening and expanding supply chains is about increasing these benefits, strengthening resilience to shocks such as pandemics, and providing opportunities to

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[17] Pol Antras, "De-Globlisation? Global Value Chains in the Post-COVID-19 Age, NBER Working Paper 28115, November 2020.

[18] Pol Antras and Alonso de Gortari 2017. "On the Geography of Global Value Chains" Econometrica, Vol. 88. N. 4 (July 2020), 1553-1598.

[19] Jan De Loecker et al 2016, "Prices, Markups, and Trade Reform", Econometrica 84(2), 445-510.

build a more inclusive digital North American economy. Success in these areas can also reduce the reliance on China-situated supply chains.

However, strengthening North American supply chains will require infrastructure investments, built-in redundancies and stockpiling inventory, and seamless information flows among participants in supply chains to better respond to shocks. To further bolster supply chains and increase resiliency as well as support the transition to digital supply chains, the U.S., Mexico, and Canada need to work together and use USMCA to support increased investment in new supply chains such as batteries for electric vehicles (EVs) (see Box 1), data and digital technologies such as AI and blockchains, and opportunities for SMEs.

From the competitiveness side, it is important to assess the role of services and data in supply chains. This is due to the increasing importance of services as value-added inputs in manufacturing.[20] For instance, the McKinsey Global Institute estimates that by 2030 up to 30 percent of automotive manufacturers' revenues will come from service offerings.[21] Services are used in supply chains in various ways. For one, services link manufacturing activities using telecommunications, transport, logistics, and finance; these services enable supply chains and, therefore, contribute to manufacturing efficiency and productivity.[22] Services are also used within manufacturing such as research and development, design, and engineering; these services can be outsourced or produced in-house. In addition, manufactured goods are increasingly sold together with needed services like maintenance and repair. Other services use sensors and data collection to add value to the final product by improving the efficiency and utility of the good. USMCA's liberalization of services combined with commitments on digital trade can support growth in services in North American supply chains.

Assessing the competitiveness of North American supply chains also needs to take into account other regional chains. Figure 5 shows North America as one of three key regional supply chains—alongside Asia and Europe—focused on advanced manufacturing and innovative activities. To sustain and grow its competitiveness, North America must become the most competitive destination for manufacturing. That said, trade between the U.S. and EU for example has included intermediate goods used in each other's regional supply chains. This highlights the opportunities of gains from trade from increasing levels of specialization and underscores a broader point: To increase

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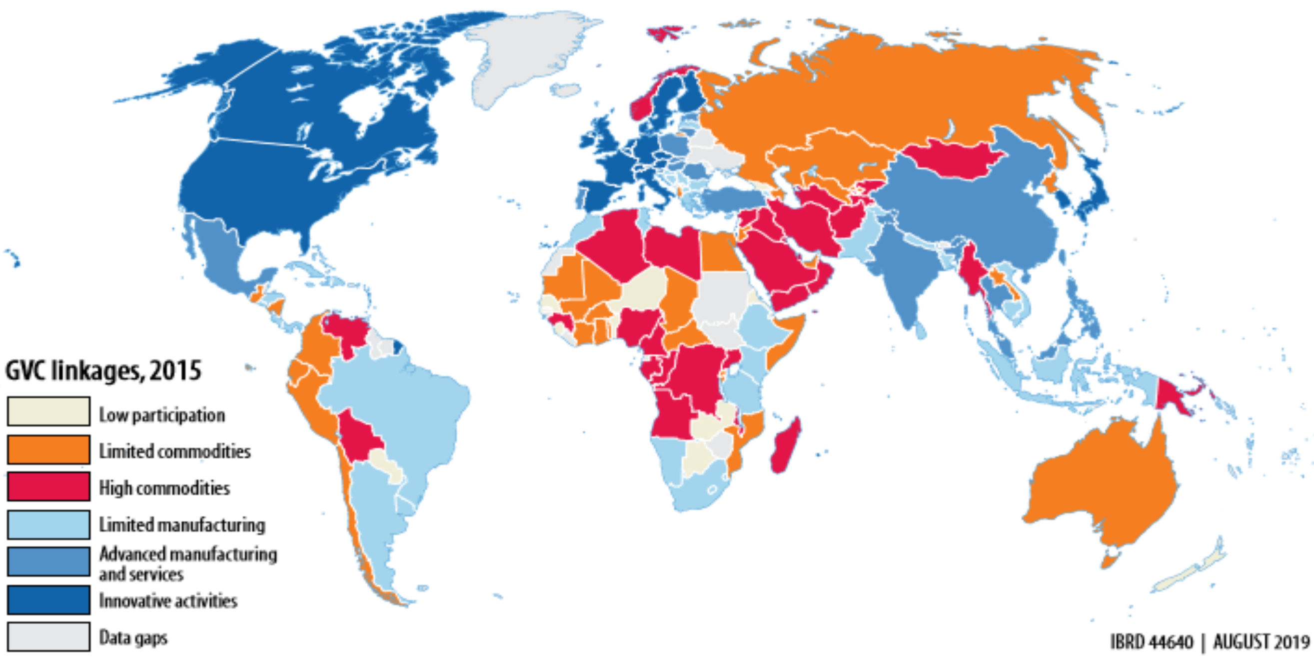
[20] Lanz, R. and A. Maurer (2015), "Services and global value chains -some evidence on servicification of manufacturing and services networks", WTO Working Paper, ERSD-2015-03, World Trade Organization; Miroudot, S. and C. Cadestin (2017-03-15), "Services in Global Value Chains: From Inputs to Value-Creating Activities", OECD Trade Policy Papers, No. 197, OECD Publishing, Paris., p. 8.
[21] McKinsey Global Institute, "Globalization in Transition: The Future of Trade and Value Chains", January 2019, p. 34.
[22] Miroudot, S. and C. Cadestin (2017-03-15), "Services in Global Value Chains: From Inputs to Value-Creating Activities", OECD Trade Policy Papers, No. 197, OECD Publishing, Paris., p. 8

the resiliency and competitiveness of North American supply chains, governments will need to balance the push to localization with global sourcing to increase supply chain competitiveness.

North American trade is especially dense in supply chains for a few key industries such as aerospace, auto, and medical devices manufacturing. Table 4 shows the share of North American imports for key industries in each nation (i.e., 58.3 percent of Canadian aircraft part imports are from Mexico and the U.S.):

FIGURE 5

Global value chain linkages



Source: World Bank: World Bank Development Report 2020, p. 26

TABLE 4

North American imports in important North American supply chains

Country	Aircraft Parts	Finished Aircraft	Auto Parts	Finished Autos	Medical Devices
Canada	58.3%	51.3%	82.6%	62.0%	67.6%
Mexico	50.1%	1.1%	63.1%	28.1%	79.1%
U.S.	15.2%	25.6%	49.7%	42.9%	29.4%

Source: Observatory of Economic Complexity (OEC), taken from *CEPI figures;* authors' calculations

Canadian supply chains in particular are reliant on imports from the U.S. and Mexico. While the U.S. has relatively more diverse imports for key supply chains, intra-regional trade also provides crucial components for these industries. Expanding on the data in Figure 2 showing growth in trade with China, Table 5 shows that much of this trade has included growth in the use of inputs from China in North American supply chains. For example, when it comes to aircraft parts, the U.S. sourced 3.4 percent of aircraft parts from China in 2019, up from 0.6 percent in 2000, and auto parts from China used in the U.S. auto manufacturing increased from 1.6 percent of total auto parts in 2000 to over 13 percent in 2019.

TABLE 5

Penetration by Chinese imports in major North American industries

Country	Aircraft Parts		Finished Aircraft		Auto Parts		Finished Autos		Medical Devices	
Canada	0.1%	4.8%	<0.1%	<0.1%	0.2%	6.0%	<0.1%	0.5%	0.4%	2.6%
Mexico	<0.1%	1.2%	<0.1%	0.3%	<0.1%	8.1%	<0.1%	9.7%	0.3%	3.6%
U.S.	0.6%	3.4%	0.3%	1.9%	1.6%	13.4%	<0.1%	0.8%	1.6%	5.8%
Year	**2000**	**2019**	**2000**	**2019**	**2000**	**2019**	**2000**	**2019**	**2000**	**2019**

Source: Observatory of Economic Complexity (OEC) figures, authors' calculations

Expanding North American supply chains will also help reduce the economic dependence on China and potentially ease geopolitical tensions. However, for reshoring to be economically sustainable, it will require world class regional industries that can compete globally.[23] Recent research on firm-level participation in supply chains underscores their so-called "stickiness" that entails costs to both building supply changes and changing supply chains. This research makes clear that any effort to expand manufacturing in North America will require leaning into USMCA to make North America a cost-effective region for production. The USMCA competitiveness committee is well placed to engage with and support this supply chain agenda.

The Biden administration's Supply Chain Review has underscored the need for resilient supply chains that are critical to national, economic, and technological security.[24] The review notes the important role globalized supply chains play, and finds that "the United States has a strong national interest in U.S. allies and partners improving the resiliency of their critical supply chains." However, it fails to meaningfully connect resilience with strengthening production links among allies and partners. North America should be a central part of any assessment of what manufacturing should be in the U.S., and what

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[23] The White House, "Building Resilient Supply Chains, Revitalizing American Manufacturing, And Fostering Broad-Based Growth: 100-Day Reviews under Executive Order 14017", June 2021, https://www.whitehouse.gov/wp-content/uploads/2021/06/100-day-supply-chain-review-report.pdf.
[24] Acemoglu et al, "Contracts and Technology Adoption." *American Economic Review* 97:3, pp. 916-943, 2007.

manufacturing capacity should be across the region—not just in the U.S.—so that supply chains become resilient. However, many of the current recommendations seem primarily focused on increasing manufacturing production in the U.S. only.

The USMCA also has the capacity to strengthen governance such as improving investor confidence in the rule of law and enforcing contracts, which will support future investments and strengthen supply chains. However, this will require all governments to comply with their USMCA commitments. When USMCA compliance reduces trade policy risks, it can lead to increased investments in supply chains. The Trump administration's reliance on Section 232 to justify tariffs on steel and aluminum imports from Canada and Mexico undermined the USMCA's—and trade agreements more generally—ability to reduce risks and provide trade policy certainty.[25] The Biden administration's emphasis on a rules-based order and its willingness to use dispute settlement to resolve trade issues are important steps to reaffirming U.S.' commitment to international law. More generally, if the U.S. is serious about improving the attractiveness of North America as a base for investing in supply chains, it needs to also support the trade policies that can make this happen, including clarifying and limiting use of Section 232 tariffs.[26]

Focusing on regional supply chains as the building block for more resilient supply chains also requires strong communication and trust between governments so they can rely on each other during times of crisis. The USMCA competitiveness committee may be a platform for such trust building and dialogue. The failure of governments in the U.S., Mexico, and Canada to coordinate on the designation of essential sectors as well as export controls at the beginning of the pandemic created needless supply chain disruptions.[27] Developing better processes to coordinate such policies ahead of time is needed to build trust and capacity among the three countries so they are able to maintain functional supply chains during times of crisis.

Finally, supply chains can increase wage inequality where it leads to heightened demand for higher-skilled workers.[28] A worker-centric trade policy should acknowledge this and focus on building human capital for supply chain participation. This should include expanding opportunities for retraining and starting new businesses and helping workers

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[25] Antras, Pol, "Conceptual Aspects of Global Value Chains," World Bank Policy Research Working Paper 9114, pp. 20-21, 2020.

[26] Marc L. Busch, "It's time to end the US steel and aluminum tariffs, The Hill, August 9th, 2021.

[27] Joaquin Contreras, Paul Lalonde, Sean Stephenson, Cody Wood (Dentons): "North American trade in the time of COVID-19." (June 5, 2020).

[28] Andoni F. Barusman and Dr M. Y.S. Barusman 2017., The Impact of International Trade on Income Inequality in the United States since 1970"m European Research Studies Journal Vol XX, Issue 4A, 35-50; Pinelopi K Goldberg and Nina Pavcnik 2007., " Distributional Effects of Globalization in Developing Countries", Journal of Economic literature Review, 45:1, 39-82

relocate from depressed regions to areas where jobs are located.[29] Failure to deliver a broader set of labor market adjustment policies will hold American workers back and could create unrealistic expectations on what USMCA can deliver for workers. This could expose USMCA—and trade more broadly—to another worker backlash during an economic shock.

Box 1: Strengthening the battery supply chain in North America

Developing batteries for electric vehicles (EV) is a priority for the Biden administration to increase manufacturing, strengthen supply chain security, and help address climate change. Currently, the U.S. is dependent on China for a range of components including the final battery. Growth in the EV market will matter for North America given the dominance of automobiles in North American trade.

Moving to EV production will require retooling production lines currently based around combustion engines and reskilling workers. There are also opportunities for increased North American production along the entire battery supply chain, including producing raw materials such as lithium, Class 1 Nickel, and Cobalt, developing refining capacity, and expanding production of finished battery packs. This is supported by USMCA requirements on battery production; to qualify for lower tariffs, the work must take place in North America.

More generally, USMCA's support for innovation, data flows, and skills upgrading can make North America a more competitive destination for battery production. At the same time, the U.S., Canada, and Mexico will need to reckon with unfair Chinese commercial and trade policies, including subsidies to Chinese firms, third market dumping, forced technology transfers, and opaque certification requirements for foreign suppliers selling in China that seem aimed at extracting intellectual property (IP) on cell composition.[30]

3. Develop a digital North America

The U.S., Mexico, and Canada should take advantage of the USMCA to develop the world's most integrated digital economy that maximizes opportunities for cross-border

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[29] Gordon H. Hanson, 2021. "Can Trade Work for Workers? The Right Way to Redress Harms and Redistribute Gains", Foreign Affairs, Vol. 1000, No. 3, p. 20-29.
[30] John D. Graham, Keith B. Belton and Suri Xia, "How China Beat the US in Electric Vehicle Manufacturing", Issues in Science and Technology, Vol XXXVII, No. 2 Winter 2021. https://issues.org/china-us-electric-vehicles-batteries/

data flows and digital trade, while still preserving privacy and ensuring cybersecurity.[31] Various types of data provide increasingly important information for businesses and government, from developing digital technologies such as AI, driving business insights, effectively managing supply chains, and enhancing innovation and delivery of government services. Cross-border data flows are also transforming international trade[21] through e-commerce, digital services delivery, and data use in manufacturing.[32]

E-commerce is a major industry, totaling $14.5 billion in Mexico and $25.4 billion in Canada. It also provides a pathway for SMEs to engage in international trade.[33] For instance, 100 percent of Mexican small businesses using eBay are exporters, compared to 8 percent of traditional offline Mexican SMEs.[34] Moreover, the broader use of digital technologies has the potential to boost Mexico's GDP by 7 to 15 percent by 2025.[35] For example, data collected from sensors is being used to improve logistics, and AI-enabled translation services have reduced language barriers to trade.[36] Furthermore, global data flows are enabling so-called "Supply Chain 4.0" that includes integrated information flows that can enhance productivity and expand employment opportunities.[37] This includes creating new opportunities for SMEs to participate in supply chains by taking on tasks or offering services.

The USMCA contains the world's most comprehensive chapter on digital trade. They cover commitments to supporting cross-border data flows, avoiding data localization, and prohibiting requirements on source code as a condition of market access. These measures provide certainty to businesses that rely on data.[38] USMCA can also strengthen e-commerce as a driver of trade by including requirements for raising De Minimis duties and improving customs facilitation and express delivery.[39] However, as digital trade opportunities grow, governments are enacting restrictions on cross-border data flows. The U.S., Canada, and Mexico remain relatively liberal in their approach, at least compared to some countries in Southeast Asia, China, and the EU.

EU regulation of privacy under General Data Protection Regulation (GDPR) and approaches to data governance and AI may present new challenges to data flows and

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[31] Joshua P Meltzer, "The United States-Mexico Canada Agreement: Developing Trade Policy for Digital Trade", 11(2) Trade L. & Dev. 239 (2019**).**

[32] USITC 2014, "Digital Trade in the U.S. and Global Economies, Part 2", Pub. No 4485, August 2014, p., 275.

[33] Joshua P. Meltzer Governing Digital Trade, 18 World Trade Rev.S23 (2019).

[34] Ebay, Small Online Business Growth Report" 2016.

[35] Max Cesar et al, How Mexico can become Latin America's digital-government powerhouse", McKinsey & Co, November 2018.

[36] Brynjolfsson et al., *Does Machine Translation Affect International Trade? Evidence from a Large Digital Platform*, NAT'L BUREAU ECON. RESEARCH (Aug. 1, 2018).

[37] Michael J. Ferrantino & Emine Elcin Koten, *Understanding Supply Chain 4.0 and its Potential Impact on Global Value Chains*, *in* THE GLOBAL VALUE CHAIN DEVELOPMENT REPORT 2019, TECHNOLOGICAL INNOVATION, SUPPLY CHAIN TRADE, AND WORKERS IN A GLOBALIZED WORLD 105, 106 (Apr. 15, 2019).

[38] USMCA Article 19.16.

[39] USMCA Article 19.5.

EU market access.[40] This presents a unique opportunity for North America—through the USMCA—to develop its own approach to digital trade and economy that sets common standards and regulatory approaches, which respects privacy without unnecessarily restricting data flows and digital trade. There are specific USMCA commitments to cooperate on digital trade issues that should be utilized, including sharing experience on how to increase access to government data while preserving privacy. USMCA also includes a global commitment to cybersecurity that acknowledges the need to build cyber capacity, strengthen collaboration on cyberattacks, and share best practices.[41] Addressing the issue of cyberattacks will be central to building a secure digital economy and resilient global value chains and enabling data flows with trust.[42]

North America is well-positioned to lead on cyber issues, from developing capacity among government and the private sector to setting principles and regulation. In this respect, USMCA recognizes the importance of risk-based approaches to cybersecurity, which rely on consensus-based standards and risk management best practices. The U.S. NIST Cybersecurity framework leverages international standards to guide cyber practice in the private sector and could be a basis for a North American approach to cybersecurity.

4. Strengthen outcomes for labor

Labor reform in Mexico has been an important priority for the U.S. This reflects the longstanding concern over the impact of lower Mexican wages on reducing investment in U.S. manufacturing, with impacts on U.S. jobs and wage rates.[43] The Mexican manufacturing sector has produced the lowest average wages growth among OECD countries as well as low productivity growth.[44] Figure 6 shows that China's wage growth has been 150 percent higher than in Mexico. The underlying driver of low wage growth is low productivity, which has defined the Mexican economy for the past decades. In particular, productivity growth in Mexico's manufacturing sector has been about half that of the U.S.[45] This is despite the enormous progress on increasing exports of complex

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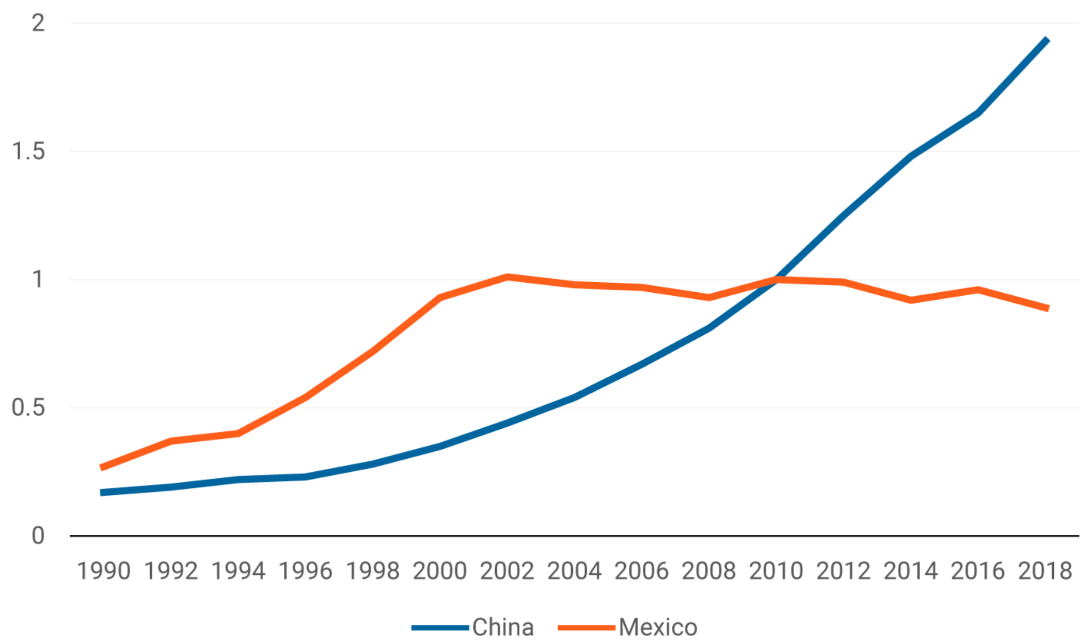
[40] Daigle, Brian, and Khan, Mahnaz (United States International Trade Commission). "The EU General Data Protection Regulation: An Analysis of Enforcement Trends by EU Data Protection Authorities." June 2020.
[41] USMCA Article 19.15.
[42] Osaka G20 Leaders Statement 2019
[43] Hanson, Gordon. "What Happened to Wages in Mexico Since NAFTA?" *NBER Digest No. 9* (September 2003). https://www.nber.org/digest/sep03/what-happened-wages-mexico-nafta.
[44] OECD. "Mexico Policy Brief: Addressing the Productivity-Inclusiveness Nexus." January 2020. https://www.oecd.org/policy-briefs/Policy-Brief-Mexico-Addressing-the-productivity-inclusiveness-nexus-EN.pdf.
[45] Ramon Padilla-Perez et al 2017. "Structural Change and productivity growth in Mexico, 1990-2014, Structural Change and Economic Dynamics 41 (2017) 53-63

manufactured products such as cars and computers, and successful integration into global value chains in North America.[46]

FIGURE 6

China and Mexico manufacturing wages

Constant 2018 US dollars; 2010=1.00



Source: The Conference Board (2020); Mexican Economic Ministry.

USMCA now contains the most comprehensive set of binding labor commitments and novel enforcement mechanisms of any trade agreement. It includes a rapid response mechanism, which expedites the process for handling alleged violation cases.

These USMCA labor commitments were an important factor that led to the broad bipartisan support of USMCA in Congress and propelled the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) to endorse the agreement—the first time the largest federation of American unions has endorsed a trade agreement. In a speech by U.S. Trade Representative (USTR) Katherine Tai, she stated that "Enforcing the higher labor standards in the USMCA is a core pillar of the Biden-Harris administration's worker-centered trade policy".[47] The Biden administration has demonstrated the importance of making progress on labor conditions by its willingness

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[46] Abhilasha Singh and Jesse Rogers, " Mexico's Productivity Puzzle: What the State Economies Can Tell Us", Moddy's Analytics, June 2017.
[47] Katherine Tai, "Outlining the Biden-Harris Administration's Worker-Centered Trade Policy (AFL-CIO town hall, Washington, DC, June 10, 2021; https://ustr.gov/about-us/policy-offices/press-office/speeches-and-remarks/2021/june/remarks-ambassador-katherine-tai-outlining-biden-harris-administrations-worker-centered-trade-policy.

to use the rapid response mechanism. This year, USTR has used this process to handle workers' rights violations in Mexico by the American auto firms Tridonex and General Motors.

The administration has also financially backed this approach, securing nearly $50 million from Congress to support Mexico's trade enforcement under USMCA. The U.S.' hope is to improve Mexico's labor conditions and wage rates through USMCA's labor commitments and start a trend towards wage convergence with the U.S. by prohibiting labor practices that stifle demands for higher wages. These labor provisions could have localized effects on Mexico's export-orientated sectors including higher than average growth in wages. However, in the absence of more substantial reforms—social, tax, and structural—it is unlikely to drive a trend to convergence with U.S. wages. Without reform of Mexico's social insurance programs and tax regime that are currently pushing workers into the informal economy and encouraging firms to remain small, Mexico's long-term low productivity rate and wages are likely to persist.[48] In the absence of structural reforms that get at these underlying drivers of low wages and productivity, Mexican wage rates are likely to stagnate. In addition, the new restrictive elements of USMCA may reduce trade and slow down Mexican productivity even more, potentially further depressing wages growth.[49]

5. Support ambitious climate change action

Addressing climate change is a priority for the U.S. and Canadian governments. At President Biden's Leaders Summit on Climate in April 2021, the U.S. increased its target for reducing greenhouse gas emissions from 50 to 52 percent by 2030 compared to 2005 levels. Canada similarly raised its level of ambition to reduce emissions from 40 to 45 percent by 2030 compared to 2005 levels, up from its previous pledge under the Paris Agreement of a 30 percent reduction. Under the same agreement, Mexico has committed to a 22 percent reduction of greenhouse gas (GHG) emissions and 51 percent of black carbon, as well as to generate 35 percent of power through clean energy sources by 2024 and 43 percent by 2030. President Biden and President Obrador have also agreed to explore bilateral cooperation on climate.

Addressing climate change presents a range of opportunities for North American cooperation that can also strengthen competitiveness and build resilient supply chains. One way is to use USMCA to drive innovation and investment in clean energy needed to

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[48] Santiago Levy, "Under-Rewarded Efforts: the elusive quest for prosperity in Mexico", IDB 2018.

[49] Carlos Rodriguez-Castelan et al, The Effects of Local Market Concentration and International Competition on Firm Productivity: Evidence from Mexico", World Bank Policy Research Paper April 2020; Dan Ciuriak and Robert Fay, "Prospects under the North American Trade Regime", in Aliza Chelminsky, Bernadette G. Vega Sánchez and Jorge O. Armijo de la Garza (eds). Implementing the USMCA: A Test for North America. Mexico City: Senado de la República, January 2021: 45-66.

meet climate change targets. There is a range of climate action coming out of the Leaders Summit that will spur clean technology investments including carbon capture and energy storage.[50] In all these areas, there should be a regional approach—that builds on USMCA—to spur investments and develop new supply chains. Reforms on enhancing competitiveness and strengthening the investment environment will be important. Actions to increase North American competitiveness will also support supply chains in areas important to climate change issues such as EV battery productions and Photovoltaic or PV solar systems.[51]

Another area to address is policies that undercut clean energy, particularly ones that lead to carbon intensive energy sources. For example, the Mexican government's Electricity Industry Law eliminates the energy regulator Comision Federal de Electricidad's (CFE) preferences for clean energy or other incentives that would grow Mexico's clean energy sector. Instead, the existing law prioritizes fossil fuels. Not only is this inconsistent with Mexico's USMCA commitments, but it is at odds with Mexico's Paris Agreement pledge to build a low carbon economy. Such actions disincentivize investments in Mexico's clean energy sector and jeopardize Mexico's role as a supplier of clean technologies. There is, therefore, an opportunity for the U.S. and Canada to challenge the consistency of Mexico's Energy Reforms with its USMCA commitments.

Another role for USMCA is developing a coordinated approach to dealing with carbon border adjustment mechanisms (CBAM). The EU CBAM extends its domestic carbon price to imports at the border. The effects of the EU CBAM will need to be assessed through a North American lens such as when the mechanisms apply to carbon intensive products—particularly iron, steel, and aluminum—produced through North American value chains. At the same time, Canada is considering whether it should develop a CBAM to support its more ambitious climate targets.[52] Trade Representative Tai has signaled that USTR is also looking at this issue[53] and proposed a bill for climate border adjustment, signaling a growing interest in Congress to act on this important issue.[54] North America needs to develop a unified approach to CBAM to prevent it from becoming a trade barrier. This requires a coordinated approach to developing a regional mechanism as well as reducing the carbon intensity of exports.

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[50] Leaders Summit on Climate Summary of Proceedings https://www.whitehouse.gov/briefing-room/statements-releases/2021/04/23/leaders-summit-on-climate-summary-of-proceedings/.

[51] PWC, "Changing lanes. As autonomous vehicles transform the value chain, what moves will you make?", November 2019, https://www.pwc.com/us/en/industries/industrial-products/library/autonomous-vehicles-value-chain.html.

[52] https://www.canada.ca/en/department-finance/programs/consultations/2021/border-carbon-adjustments/exploring-border-carbon-adjustments-canada.html

[53] USTR Trade Policy Agenda and Annual Report 2021.

[54] S.2378 and H.R. 4534 FAIR Transition and Competition Act.

While USMCA has been criticized for failing to explicitly include climate change commitments, there are a number of provisions that support climate action.[55] For instance, the USMCA's chapter on the environment includes expanding access to climate finance and clean technology innovation and commitments to sustainable forestry management, which reduces deforestation and builds forests as carbon sinks.[56] The USMCA strengthens restrictions on ozone-depleting substances under the Montreal Protocol that are also potent greenhouse gases.[57] USMCA also includes commitments to facilitate trade and investment in environmental goods and services by working through the USMCA Environment Committee as well as through international fora such as the WTO.

The U.S., Mexico, and Canada should use USMCA to develop an ambitious agenda around trade in clean technology goods and services. Progress here can stimulate production of clean technologies in North America. This will be particularly the case if there is agreement to ratchet up and harmonize energy efficiency standards in North America where the USMCA Annex 12-D on energy performance standards requires cooperation.[58] A successful USMCA outcome on reducing barriers to environmental goods and services could become a basis for renewing WTO negotiations on environmental goods.[59]

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[55] Amanda Maxwell and Dan West, USMCA is a Huge Missed Opportunity to Act on Climate, NRDC, Dec 19 2019 https://www.nrdc.org/experts/amanda-maxwell/usmca-huge-missed-opportunity-act-climate
[56] USMCA Article 24.23, 24.24.
[57] USMCA Article 24.9.
[58] Russell Bishop, 2015. Raising Energy Efficiency Standards to the Global Best. Contributing paper for Seizing the Global Opportunity: Partnerships for Better Growth and a Better Climate. New Climate Economy, London and Washington, DC.
[59] See generally James Bacchus and Inu Manak, "Free Trade in Environmental Goods Will Increase Access to Green Tech", CATO Institute Free Trade Bulletin, Number 80, June 8, 2021.

Conclusion

USMCA presents a unique opportunity to reimagine North American economic relations and build a more competitive, sustainable, and inclusive North American economy. Growing geopolitical competition with China coupled with the need to strengthen supply chains—in part by reducing economic reliance on China—also underscores the importance of USMCA.

This report outlines five main areas where progress is needed: building a more competitive North American economy; ensuring resilient supply chains; expanding digital trade; supporting improvements in wages and working conditions; and addressing climate change. These goals are deeply interlinked: A more competitive North American economy must include more resilient supply chains in areas such as clean technology. Progress in this sphere would support ambitious climate policy and, therefore, a more sustainable North American economy. A more competitive North American economy will be needed to sustain the drive to re-shore critical supply chains and take on the broader competition with China. Workers across the region will need to upskill as supply chains become increasingly knowledge intensive as data use and digital technologies are mainstreamed across manufacturing and many services sectors. Moreover, by supporting wage growth, USMCA can help build a more inclusive economy, expanding the domestic market that also benefits businesses, and helping sustain the political commitment needed to pursue closer economic integration.

USMCA can be used to make progress in all these areas through its wide-ranging commitments, committee work, and regulatory cooperation. However, for USMCA to be truly effective, the three countries—U.S., Mexico, and Canada—will need to comply with the commitments outlined in the agreement. This is particularly important given the Trump administration's disregard for U.S. trade commitments, which raised considerable economic uncertainty and instability. More recently, Mexican President Obrador's proposed electricity and energy markets reforms are likely at odds with the country's USMCA commitments.[60] When breaches of the agreement arise, it is important to demonstrate the effectiveness of the USMCA dispute settlement mechanism. In this

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[60] Mexico's Reforms to Hydrocarbon Law and Electricity Industry Law May Violate Investment Treaty Protections, Gibson Dunn, June 1, 2021 https://www.gibsondunn.com/wp-content/uploads/2021/06/mexico-reforms-to-hydrocarbon-law-and-electricity-industry-law-may-violate-investment-treaty-protections.pdf.

regard, the use of the USMCA dispute settlement mechanism to address U.S. concerns with Canada's dairy tariff-rate quotas, Canada's challenge to U.S.' measures affecting solar panels, and Mexico's disagreement with how the U.S. calculates auto rules of origin, are positive signs that the governments are effectively utilizing the agreement to resolve trade disputes.

For USMCA to succeed, the trade agreement will need to be viewed not only as a practical and functional economic pact, but as a living symbol of effective North American economic relations. One that is built on mutual trust, commitment to the agreed standards, and a true regional partnership. When the three countries at all levels of government, business, and civil society view each other as key partners faced with the same challenges and opportunities, USMCA can then be an effective vehicle for meaningful regional integration and cooperation.

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