



CANADIAN GLOBAL AFFAIRS INSTITUTE
INSTITUT CANADIEN DES AFFAIRES MONDIALES

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by Colin Robertson
October, 2017

POLICY UPDATE

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Prepared for the Canadian Global Affairs Institute
1800, 421 – 7th Avenue S.W., Calgary, AB T2P 4K9
www.cgai.ca

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ISBN: 978-1-988493-66-4



It's fish-or-cut-bait time for the NAFTA renegotiations.

Negotiators reassemble in Washington this week (Oct. 11-15) with their sights on the elephants in the room – the U.S. demands around dispute settlement, rules of origin, “Buy American” on procurement and a sunset clause.

The Americans, who initiated these renegotiations to reduce the U.S. trade deficit, are expected to lay out their positions on the various “elephants”. There are also U.S. demands specific to Canada – supply management – and specific to Mexico – wages, trucking and agriculture exports.

For Prime Minister Justin Trudeau, who this week will see first President Donald Trump in Washington and then President Enrique Peña Nieto in Mexico City, it will be a test of personal diplomacy. Can Trudeau persuade his counterparts to compromise on the “elephants” and keep the negotiations moving forward?

At the midway point in the scheduled seven rounds, the low-hanging fruit – chapters on small and medium-sized enterprises, competition, transparency and anti-corruption – are ready for harvest. They will likely resemble what had been previously negotiated in the stillborn Trans-Pacific Partnership (TPP) agreement. Trump withdrew the U.S. from the TPP shortly after his inauguration.

The auspices going into this round are not good.

Trump promised to put “America First” and he is delivering. From Jan. 20 through Sept. 20, 2017, the Commerce Department has [initiated 65 Anti-dumping \(AD\) and Countervail \(CVD\) investigations – a 48 per cent increase](#) from the previous year and a [16-year peak](#) in the number of initiated investigations.

The U.S. Commerce Department has sided with Boeing in making protectionist [decisions](#) against Bombardier's sale of its C-series jets. Inspired [leaks](#) that the U.S. side will seek to impose 50 per cent Made-in-America content on the North American manufacture of autos follow on the heels of Commerce Secretary Wilbur Ross's *Washington Post* piece: “[NAFTA Rules are Killing our Jobs](#)”. In an unfortunate turn of phrase, Agriculture Secretary Sonny Perdue said agricultural trade policy is “[like policy toward North Korea](#) – all options are on the table”. Perdue [promised](#) to press Canada's supply management policy and consider seasonal limits on [Mexican produce](#).

President Trump's continued [musings](#) – “bring me some tariffs”, “I happen to think that NAFTA will have to [be terminated](#) if we're going to make it good.” and [tweets](#) about rescinding NAFTA only aggravate the situation. Mexican Foreign Minister Luis Videgaray has said that Mexico would [leave the negotiations](#) if the U.S. gave notice that it was invoking NAFTA article 2205 rescinding the agreement.



After Washington, another round is scheduled weeks later in Mexico City. If there is deadlock on the “elephants”, negotiations could take a long pause, or be suspended. Finishing the negotiations by Christmas is doubtful especially given the kind of detail work, for example, that would have to go into the tracing formulas for rules of origin. Passage through Congress will also require real effort from the administration and its track record so far (repeal of Obamacare, tax reform, infrastructure spending) is not encouraging. The Trump administration continues to be understaffed, politically inexperienced and chaotic.

The biggest unknown is Trump himself.

Trudeau meets Trump this week in the White House and then goes to Mexico City to see Peña Nieto. Trump came close to rescinding NAFTA on day 100 of his administration. He continues to make threats about scrapping NAFTA. Is it another example from Trump’s playbook, *The Art of the Deal*? Is he serious about renegotiation or is he simply dangling increasingly unacceptable offers that would oblige a suspension or breakdown in negotiations? Mr. Trudeau should politely tell Mr. Trump to fish or cut bait.

Foreign Minister Chrystia Freeland has suggested that Mr. Trudeau will “explain really clearly to the President ... that [Canada is not America’s problem](#).” Some have suggested that this is a gentle poke at Mexico. This would be a strategic mistake and it would play directly into the divide-and-conquer tactics that Mr. Trump describes in the *Art of the Deal*. Mexico is a good neighbour, fellow middle power and our third largest trading partner. We need to build on this relationship.

For now, Canada and Mexico must redouble their advocacy efforts in the U.S., especially at the state and local level, to put pressure on the Trump administration if NAFTA is to be revised and not rescinded.

Elephants in the Room I: Rules of Origin

The U.S. wants to revise the current rules of origin to ensure a higher percentage of this U.S.-only content. Secretary Ross claimed in a recent *Washington Post* [column that](#), “these NAFTA rules are killing our jobs”. The numbers he used are suspect, argues former Mexican trade negotiator [Luis de la Calle](#). The Peterson Institute’s [Caroline Freund](#) writes that U.S. content requirement in NAFTA could hurt U.S. manufacturing.

Rules of origin were first introduced in the Autopact (1965) to ensure most of the production took place in Canada and the U.S. and then the Canada-U.S. Free Trade Agreement (CUSFTA) and NAFTA extended this principle. To qualify as made in North America, autos must have 62.5 per cent content, i.e., parts, made in Mexico, the U.S. or Canada. Cars now contain an average of [30,000](#) parts (when we did NAFTA it was closer to 20,000 parts). Before a car is assembled, it crosses the Canada-U.S. border an average of seven times.

During the TPP negotiations, U.S. Trade Representative Mike Froman was prepared to lower the current threshold to less than 50 per cent in order to do a U.S. deal with Japan. Canada and



Mexico protested but the decider was the U.S. congressional auto caucus, which forced Froman to back down.

Recent leaks in [Inside US Trade](#) suggest that USTR Robert Lighthizer wants a 50 per cent U.S. domestic content requirement. The suggested U.S. proposal would increase the NAFTA regional value content requirement from 62.5 per cent to 85 per cent and include an expanded tracing list that includes all components of a car. Supply chains are carefully designed to ensure quality, timely delivery and best price, so disrupting current processes is not something the manufacturers, parts-makers or tertiary suppliers want to see. [UNIFOR and the UAW](#) want more made in Canada and the U.S., arguing that Mexican wages are kept artificially low.

Elephants in the Room 2: Dispute Settlement

Dispute settlement covers two dimensions: investor state and trade remedies. The U.S. wants to remove both chapters from the agreement and have disputes settled solely through the U.S. trade remedy system. This is a red line for Canada and Mexico. The Trump administration sees dispute settlement as an infringement on U.S. sovereignty; it is taking a hard line not just in NAFTA renegotiations, but also at the World Trade Organization (WTO), [blocking appointments](#) of new appellate judges to the Dispute Settlement Body (DSB).

Investor-state dispute settlement (ISDS) currently contained in NAFTA's Chapter XI, was included at the Americans' behest to prevent appropriation of investments in Mexico. However, it has been applied mostly against Canada, usually over initiatives taken by a provincial government for which the federal government must pay the price.

As trade scholar Larry Herman observes, "the successful Chapter 11 claims against Canada would be in the order of \$320 million versus \$5.0 billion claimed or approximately 6.4% of total damages claimed over 23 years. While this is still substantial, it does put these amounts in perspective." TransCanada had filed a [\\$15 billion](#) suit under Chapter XI over former president Barack Obama's rejection of the Keystone pipeline permit but it was [suspended](#) after Trump issued the permit.

We are not sure yet what the Americans want to do on ISDS. Given our experience, we are promoting institutionalization of permanent courts to provide more certainty in case law and more transparency in deliberation. We took this approach in the Canada-European Union Comprehensive Economic and Trade Agreement (CETA) and TPP.

Trade Remedy, or Chapter XIX, deals with disputes related to countervail (products with prices lower than the cost of production) or anti-dump (products produced with subsidies). Examples include the softwood lumber dispute and now Boeing's [complaint](#) about Bombardier.

U.S. trade remedy afflicted Canadian products – raspberries, lumber, fish – during the lead-up to the original CUSFTA negotiations in 1985. Dispute settlement was essential to Canada in its negotiation of CUSFTA and NAFTA. Canada would have walked if we had not secured tribunals



independent of the U.S. trade remedy system. The Mexican congress passed a non-binding [resolution](#) shortly before the negotiations began, insisting that we maintain Chapter XIX.

Herman [notes](#) that, softwood lumber excepted, Chapter XIX has not been used as much in recent years – some argue its very presence keeps the system honest.

Could improvements be made to Chapter XIX? Yes, but what form they will take must be negotiated. As with tracing rules of origin, the devil is always in the detail.

Elephants in the Room 3: Five-Year Sunset Clause and Government Procurement

The proposed [five-year sunset clause](#) is a non-starter for Canada and Mexico, and business in all three countries opposes it because it removes certainty around investments. As Canadian Ambassador David MacNaughton wryly observed: “If [every marriage](#) had a five-year sunset clause on it, I think our divorce rate would be a heck of a lot higher than it is...One of reasons you do (a trade agreement) is to create an environment within which business can make investments. (In) many of those investments people will look to 20 years', 25 years' payback. If you have to do it every five years, the pricing of political risk is very high.”

U.S. negotiators are proposing a “dollar for dollar” opening of North American procurement markets that would greatly reduce Canadian and Mexican access to the U.S. market. Canada and Mexico want to curb, if not exclude, ‘Buy American’ provisions at the federal and state level but the [U.S. wants to roll back](#) its NAFTA commitments.

Ongoing Disputes: Softwood Lumber and Bombardier-Boeing

Softwood lumber negotiations continue outside of NAFTA. The relevant provinces – British Columbia, Alberta, Ontario, Quebec and New Brunswick – have all appointed special envoys. It is hard to see an early resolution. If history is any guide, resolution won't happen until the pot is sweetened with Canadian cash. Even then, we will likely wind up with another managed trade deal of five years' duration. Not a great solution.

The Boeing-Bombardier dispute is potentially more dangerous and could affect the negotiations in the same fashion that shakes and shingles nearly scuttled the CUSFTA negotiations in 1985-1986. The Boeing suit against Bombardier over subsidies may have a basis but given [the subsidies](#) (state, local and federal) that Boeing enjoys, is there injury?

The Commerce Department announcement on the last day of the Ottawa round of negotiations made a statement, but embarrassed the Canadian hosts. As Trudeau repeated, Canada “will [not do business](#) with a company that is busy trying to sue us and put aerospace workers out of business”.



The Boeing suit strikes at Quebec pride in its aerospace champion. The Couillard government has framed it as an [affront](#) to Quebec. Bombardier workers live in Trudeau's riding and the Boeing officials, likely encouraged by senior Trump officials, would appear to have behaved with a surprising lack of sensitivity. BHP made the same mistake during its Potash Corp. bid and it was a major contributing factor to the deal's collapse.

The Negotiators and the Negotiations

There is good personal chemistry at the chief negotiator level. U.S. negotiator John Melle is a long-time USTR official responsible for North America. Mexican chief negotiator Kenneth Smith is another long-time negotiator and was a member of the Mexican NAFTA team in 1993 before heading Mexico's NAFTA office in Washington. Canada's chief negotiator, Steve Verheul, was chief negotiator for CETA and prior to that chief negotiator for Agriculture Canada.

Canadian Foreign Affairs Minister Chrystia Freeland and Mexican Economic Secretary Ildefonso Guajardo work together well as trade ministers. They like each other and they are in regular contact. USTR Lighthizer is a seasoned trade lawyer who served in the Reagan administration. To get a sense of the trio's dynamic, watch the body language when the three ministers are together.

Negotiations are taking place at 28 tables. Chapters covering telecoms, small and medium-sized enterprises, competition and food safety are [essentially done](#) and they are close to closing those on digital trade and anti-corruption. To get a sense of what these chapters might look like as well as the format of the new North American accord, look to the 30 chapters in the [Trans-Pacific Partnership Agreement](#) that was signed a year ago February in New Zealand but which Trump rejected. Ironically, the U.S. negotiating team is using the TPP language for much of their suggested draft language for the NAFTA 2.0 text.

Canada and Mexico want to expand the list of business travellers eligible for the NAFTA fast-pass into the digital age. There may or may not be an energy chapter (the U.S. leans against it). If there is, it would include Mexico. Regardless, there is continuing trilateral co-operation on energy with regular ministerial meetings and efforts to consolidate and ease the flow of oil, gas and electricity through the 150 Canada-U.S. crossings and the 81 refineries that import Canadian oil or gas.

No surprise – the U.S. is pushing Canada on supply management around dairy. The likely give here (in return for something from the U.S.) would be more quota for U.S. producers similar to that given to the Europeans in CETA. We should reform our dairy industry, given the growing demand for protein in Asia. We should look to the examples of New Zealand and Australia, who shed supply management to become world-beaters in dairy products.

The U.S. wants Canada to raise the customs threshold (*de minimus*) for packaged goods (currently \$20 and for Mexico \$50 USD) to something approaching their \$800, but retailers fear that they will be put out of business.



The Trudeau Visit

Prime Minister Trudeau will travel to Washington (Oct. 10-11) for meetings with President Trump and members of Congress, then to Mexico City (Oct. 12-13) to see President Peña Nieto.

The Canada-U.S. and NAFTA file have a permanent place on Trudeau's desk. His January cabinet shuffle named Chrystia Freeland as Foreign Affairs minister, leaving her with the North American trade file. Get this wrong and it will certainly not help the Trudeau government's re-election prospects in 2019. A special unit within the PMO focuses on Canada-U.S. relations and there is a cabinet committee headed by Transport Minister Marc Garneau. The Clerk has also made the Canada-U.S. relationship priority for deputy ministers.

Since January there has been a very public advocacy and outreach into the U.S. including Mr. Trudeau speaking on energy in Houston and on trade to the governors in Rhode Island. Ministers and MPs, premiers and legislators from all provinces have also been working their counterparts both in D.C. and throughout the states.

With all the balls in play, Mr. Trudeau must demonstrate the skills of a conjurer during this week's visits. He must persuade Mr. Trump that a renegotiated NAFTA serves U.S. interests while at the same time holding firm on those interests we share with Mexico – rules of origin and dispute settlement – and those specific to Canada – supply management, softwood lumber and Bombardier. Normally, the U.S. president is our shield against congressional protectionism. This time, the push is coming from the Trump administration.

In his meetings with Congress, Mr. Trudeau can point out to each congressman the trade of their state and district with Canada and the jobs that depend on Canadian trade and investment. The Canadian embassy has parsed this information in its [state fact sheets](#) and it is now complemented with an [interactive map](#) by the Canadian Business Council that identifies [7,705 Canadian-owned businesses across 434 congressional districts](#). The Canadian message is to remind Americans that Canada is their No. 1 export market and that we are a reliable neighbour and ally, pointing to, for example, Canada's commitment to increased defence spending in the recent Defence Policy Review.

Work with our U.S. Allies

In the coming weeks, Canada and Mexico will need to redouble their outreach to Capitol Hill and into each state, pointing out the benefits of trade and underlining the cost should NAFTA be rescinded. We have allies – notably the [Farm Bureau](#), [U.S. Chamber of Commerce](#) and [auto manufacturers](#) and their suppliers for whom supply chain disruption will be costly.

Warning of an “[existential threat](#)” to North American economic security, U.S. Chamber CEO Tom Donohue recently described the Administration's proposals on sunset clause, dispute settlement and rule of origin as “poison pills”. Donohue observes “U.S. exports to Canada and Mexico generate nearly [\\$37,000 in annual export](#) revenue for every American factory worker. And in the



first eight months of 2017, exports from the United States to our NAFTA partners were worth four times as much as those to China.” Rescind NAFTA warned Donohue and “The United States could then reasonably expect trade retaliation ... higher tariffs ... broken supply chains ... and potentially less cooperation on other priorities like anti-terrorism and anti-narcotics efforts. And who would be hurt the most as a result? The very Americans that this administration seeks to put first.”

What Canada Wants

In a [speech](#) at the University of Ottawa and remarks before the Standing Committee on International Trade (Aug. 14) Foreign Minister Freeland compared the negotiations to “renovating a house” and laid out her main objectives:

- Modernize the 23-year-old NAFTA to recognize the technological and digital revolution;
- Make it a progressive “fair trade” agreement, using CETA as a model, through inclusion of chapters on the environment, labour, gender equality and Indigenous peoples;
- Reforming dispute settlement to ensure governments have the right to legislate in the public interest with fair dispute settlement (Chapter XIX);
- Easing business travel (Chapter XVI), cutting red tape and focusing more on harmonized regulatory co-operation;
- Preserving supply management and cultural exception.

The progressive trade agenda is still taking definition. Environment and labour, side letters in the original NAFTA, are key elements in the progressive trade agenda along with provisions relating to the rights of Indigenous peoples and gender equality.

For a sense of what it might look like, the Canada-Chile FTA has been amended to add new chapters on sanitary and phytosanitary measures, technical barriers to trade, and trade and gender, making technical amendments to the existing government procurement chapter, and adding new, progressive elements to the investment chapter. These amendments will enter into force once both Canada and Chile have completed their respective domestic implementation processes

What If the Negotiations Break Down?

NAFTA would remain in effect between Canada and Mexico although if the TPP-11 negotiations are successful, the new TPP would effectively replace the Canada-Mexico NAFTA. If the U.S. rescinded NAFTA, Canada and the U.S. would revert to CUSFTA. This may prove a weak shield because CUSFTA contains Chapter XIX.



Rescinding NAFTA would be disruptive and hurt all three economies. At that point, most-favoured-nation tariff rates, as negotiated under the WTO, would apply. After withdrawing from the deal, the Peterson [Institute's Chad Bown](#) says that tariffs on all products would [rise](#) to an average of 3.5 per cent for the U.S., 4.2 per cent for Canada and 7.5 per cent for Mexico – a terrible deal for all.

The consumer would be the biggest loser. As we have seen with softwood lumber tariffs, it would divert trade. Instead of buying Heinz ketchup, which would be subject to a seven per cent tariff, we may switch to Salisbury or Tesco.

A rescinded NAFTA would likely have an attitudinal effect especially at the border on trade.

After CUSTFA was implemented (1989), border agents took a “pass, friend, pass” attitude. This further facilitated trade in goods, people and services. After 9/11 this facilitation attitude changed to that of security and enforcement. The border thickened. Mitigated by the Smart Border accord (2001), and the current Beyond-the-Border (BTB) and Regulatory Co-operation Council (RCC) initiatives, the ongoing NAFTA consultations have underlined that border frustrations remain the number one complaint of business.

For Canada, plan B is continuing to ease passage of goods, people and services at the border through the RTB and RCC discussions. These take place on a separate track to the NAFTA negotiations. They are making progress to reduce redundancies and duplication and on establishing a paperless, cashless and single-portal access for business.

We are likely months, rather than years, from submitting customs papers in electronic form through a single portal to Canadian and American authorities that will address all the needs of the respective departments. Originally promised under Smart Border – the accord that John Manley and Tom Ridge negotiated after 9/11, it will make the passage of goods much easier. It would avoid the problem of having to show up at the border with pages of forms and cash.

We are also making big border infrastructure investments, most notably the construction of the Gordie Howe Bridge between Windsor and Detroit, that is scheduled to open in 2022. There are also plans to improve the existing Ambassador Bridge.

There are also other instruments facilitating trade that would remain in place, most notably the Defence Production Sharing Agreement (DPSA) between Canada and the U.S. Dating back to the Second World War, DPSA is the overarching agreement from which much of the favourable defence trade treatment of Canadian companies interested in doing business with the U.S. Department of Defense (DOD) has arisen. This includes specific language in the U.S. Defense Federal Acquisition Regulation Supplement (DFARS) regarding the special DOD access for Canadian companies.

Through DPSA, the Defense Development Sharing Agreement (DDSA), and NAFTA, the U.S. and Canada each enjoy unique defence trade status with the other. With limited exception, DPSA



allows Canadian suppliers to compete for U.S. government defence contracts under the same terms applied to U.S. suppliers.

Additionally, there are the Canadian exemptions to the U.S. International Traffic in Arms Regulations (ITAR). While recent tightening of the exemptions is aggravating, it works for Canadian companies.

Canada needs to take full advantage of our current bilateral and regional agreements, most notably the [recently implemented](#) (Sept. 21) CETA. We need to put effort into creating a TPP of 11. The government has announced it is working on an [FTA with ASEAN](#). Then there are the Canada-China discussions and ongoing Canada-India negotiations. Our trade commissioner service, working with the provinces and Canadian business, needs reinvigorating to expedite commerce.

Pre-Clearance Pending...

The U.S. passed pre-clearance legislation last December and Canadian legislation is in the Senate. When it is done, then we can proceed with pre-clearance at Billy Bishop Airport in Toronto and in Quebec City, for cross-border train travel from Montreal and Vancouver and some marine ports, and pilots for rail cargo and intermodal traffic. About 12 million passengers now pass through airport pre-clearances on Canadian soil, and there are only about [five to 15 strip searches](#) per airport per year. What will happen when we pass our marijuana legislation is anyone's guess.

The Trade Deficit Question

In July, USTR Lighthizer provided Congress with a list of U.S. objectives with the underlying goal of reducing U.S. trade deficits. NAFTA negotiations began in mid-August, after the USTR secured trade promotion authority from Congress. Foreign Minister Freeland has argued that Canada-U.S. trade is virtually in balance. Even Secretary Ross puts Canada in the "[blameless deficit](#)" category because the U.S. is "not self-sufficient in energy."

But the administration seems consumed with goods, especially manufactured goods being made in America. A series of executive orders are aimed at "Buy American and Hire American" with a focus on steel and aluminum. That penny is still to drop. It could mean tariffs that will affect supply chains.

China, as we heard during the campaign, is the main target for trade action but Trump's enthusiasm is tempered by the realities of geo-politics, namely North Korea, and the recognition that China must play a key role in containing or curbing the rogue state.



Canadian Attitudes to Trade

When the Mulroney government negotiated CUSFTA in 1988, the country was divided: about 25 percent in favour, 25 per cent dead against and about half in the middle. It was the main issue in the 1988 election. While Brian Mulroney and his Progressive Conservatives won with a majority (with 43 per cent of the vote), they only carried three provinces: Alberta, Quebec and Manitoba.

This time around the Liberals and Conservatives are united behind NAFTA. Surveys say [Canadians like NAFTA](#). Canadians trust Prime Minister Trudeau to negotiate [a good deal](#) and they are also prepared to let him walk if it is not. And surveys also say that Canadians [don't think much](#) of President Trump. He is the most unpopular U.S. president in our life-time and this sentiment is shared in much of the globe.

NAFTA Worked But...

By all economic analysis – Canadian, American, Mexican, OECD, World Bank and IMF – [NAFTA has worked](#) for all three nations with trade tripling since 1994. But there continues to be a lot of misinformation and myth about its shortcomings as we witnessed during the 2016 U.S. presidential election.

NAFTA broke new ground in its day but it was drafted before the digital age. The Trudeau government sees NAFTA as an opportunity to advance its progressive trade agenda because, as Freeland told the House International Trade Committee when she put forward Canada's NAFTA objectives, "[too many working people feel abandoned by the 21st century global economy](#)." But if the gains of trade are seen to advantage only the rich and business, then populism will curb and roll back trade liberalization.

Even if most change is created by technological innovation and automation, trade is held accountable and this has led to the demonization of NAFTA since its implementation (1994) especially by U.S. Democratic politicians (including Hillary Clinton and Barack Obama) and now Trump. While congressional Democrats, with few exceptions, have traditionally opposed freer trade, Republicans until recently supported it.

Today, public opinion polls show Trump supporters to be the most vociferous anti-free traders. Ironically, the U.S. public supports freer trade.

Time is an Issue.

The Mexicans have a presidential election in July and the ruling PRI party and centre-right PAN party don't want NAFTA to intrude into the presidential campaign lest it give an advantage to the leftist candidate, Andres Manuel Lopez Obrador (AMLO), The Americans don't want it to intrude into November's mid-term elections. The timetable set by the Trade Promotion Act under which



the USTR is proceeding has a fixed congressional schedule for approval that potentially takes up to a year before the congressional up or down votes.

Further Reading

The NAFTA negotiations receive daily coverage by Canadian media. The US publications [Politico](#) and [Inside US Trade](#) have daily insights into the negotiations. CSIS Andrea Durkin edits the excellent [Trade Vistas](#) - its graphics are superb. The Wilson Center's Canada Institute is closely following the negotiations and Director Laura Dawson publishes a regular insightful [newsletter](#). The Canadian American Business Council CEO Scotty Greenwood's [weekly](#) looks at the broader Canada-US relationship. NASCO's Rachel Connell edits the useful [North American Now](#). My go-to for NAFTA trade policy commentary is the [Peterson Institute for International Economics](#). I wrote a CGAI [NAFTA Primer](#) that includes a list for further reading.

► **About the Author**

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