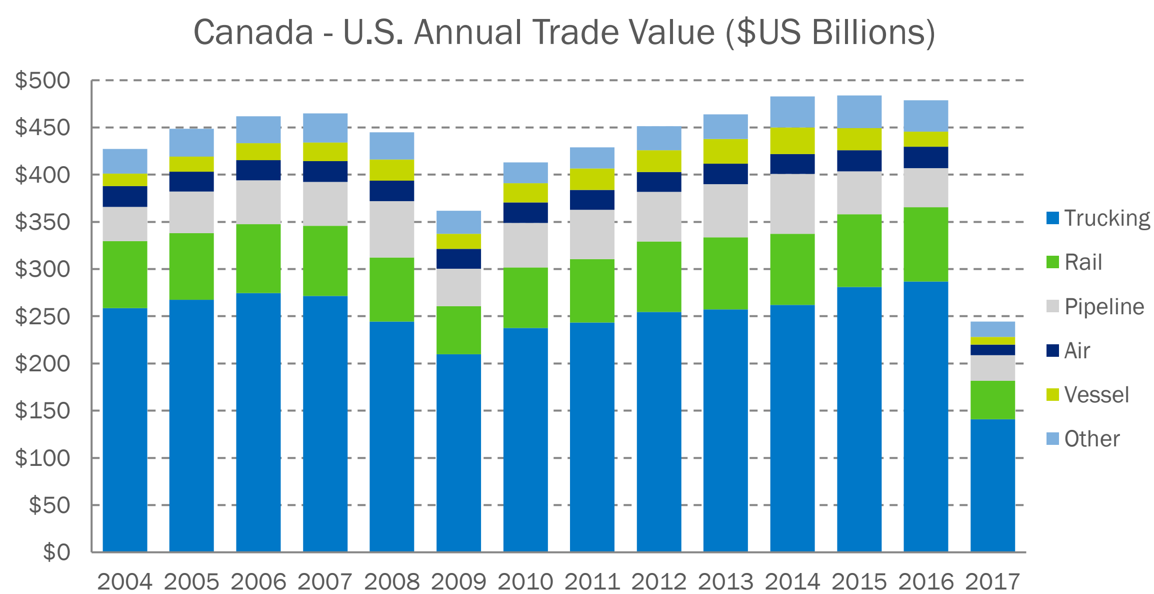
Valitas Insights: How to Prepare Your Supply Chain For a Different NAFTA

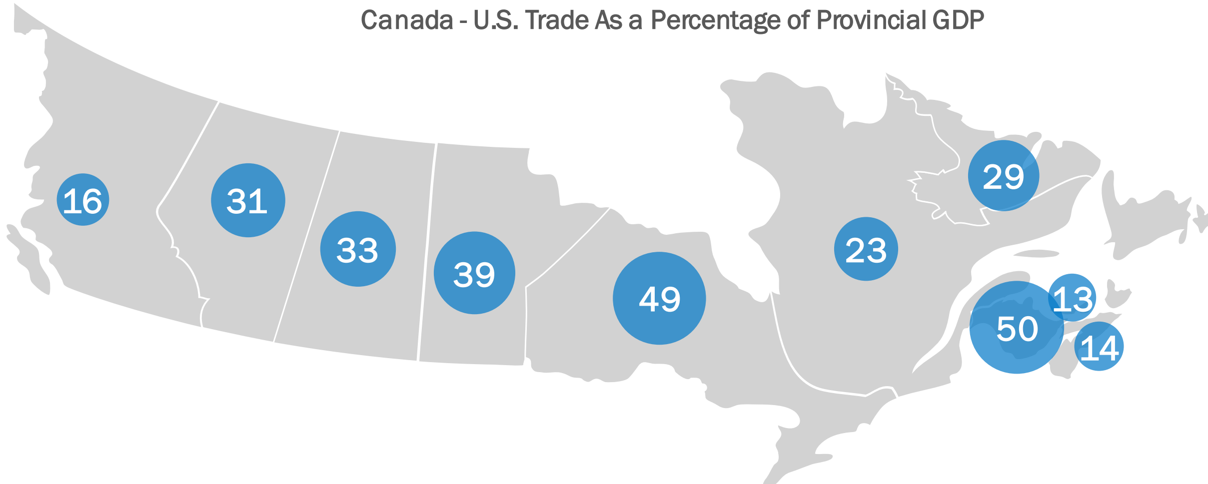
As NAFTA negotiations proceed in Washington D.C., Canadians across the country are paying close attention to how an overhaul of the trade agreement could impact their businesses. It's been years since NAFTA has been such a hot topic in the collective consciousness of either the U.S. or Canada, and just as the public interest in NAFTA has risen, so has the flow of trade between both countries.

The following graph shows the indexed value of trade (imports and exports) by freight mode since 2004. The sheer value of goods traded between the U.S. and Canada underscores the importance of NAFTA to both economies.



Source: Department of Transportation's Bureau of Transportation Statistics

There is no question that trade with the U.S. is tied to the economic performance of Canada on a provincial and federal level. The map below demonstrates the percentage of provincial GDP attributable to trade between the U.S. and Canada.



Source: Trevor Tombe, University of Calgary

Provinces, such as Ontario, New Brunswick and Manitoba, are heavily dependent on trade with the U.S., and by extension NAFTA, due to their focus on certain industries such as automotive, natural resources and agricultural products. Given that trade accounts for as much as 50% of provincial GDP, it is critical for companies and provinces to formulate strategies that address the full extent of a NAFTA renegotiation.

One key issue that needs addressing is that of supply chains. Many industries, like automotive, have structured their supply chains to take full benefit of free trade with Mexico and the U.S., thus creating complex, integrated supply networks.

For example, NAFTA enables auto parts to travel around North America with few impediments. A recent Center for Automotive Research report suggests that some auto parts and components may cross NAFTA countries' borders as many as eight times before finally being installed in a car. Changes to NAFTA could disrupt supply chains, slow production and ultimately make vehicles more expensive for consumers.

The U.S. government's protectionist agenda appears to disregard these supply chain realities while impacting companies' current expansion plans, as evidenced by Ford Motor Company's cancellation of its US$1.6 billion Mexico plant, earlier this year. In addition, during the ongoing NAFTA renegotiation, the U.S. signaled that it would like to see an increase in current content levels for the automotive sector, as well as an increase in content originating in the U.S.. As Flavio Volpe, President of the Automotive Parts Manufacturers' Association, points out, current content requirements "are already the most robust… of any free trade agreement that any of the 3 NAFTA countries is a signatory to".

According to Mr. Volpe, effective content rules strike the right balance between fostering a strong local sector and allowing that sector to source materials at competitive prices from the best suppliers. Content requirements that are too high restrict access to key raw materials, commoditized goods, and specialty items, and could therefore have considerable negative impact on supply chains.

According to a recent article by Bain & Company, companies have three main strategic alternatives to address supply chain vulnerability:

> **No-Regret Moves:** Actions that will increase a company's competitive edge no matter what scenario plays out
>
> **Options and Hedges:** Management teams develop various strategic options and hedges that can be selected as potential future scenarios unfold
>
> **Big Bets**: Large scale investments with varying payoffs according to how the future plays out

	No-Regret Moves	Options and Hedges	Big Bets
Potential Moves	▪ Improve cost management ▪ Procurement effectiveness ▪ Supply chain improvements ▪ Tighter inventory management	▪ Expand procurement options ▪ Increase volume from local suppliers ▪ Expand in existing domestic and foreign markets ▪ Invest in automation of operations	▪ Increase production capacity ▪ Enter new foreign and domestic markets ▪ Move operations from abroad to Canada ▪ Switch suppliers from foreign to local
Key Signposts during NAFTA Renegotiations	▪ Can be launched regardless of signposts	▪ Meetings ▪ Negotiation positions ▪ Consultation ▪ News/interim announcements ▪ Other free trade agreements withdrawn/signed ▪ Foreign exchange fluctuations	▪ News/interim announcements ▪ Other free trade agreements withdrawn/signed ▪ Foreign exchange fluctuations

Source: Bain & Company

The suitability of each of these options, or combination thereof, depends on the specific supply chain challenges facing each company. By developing potential strategies while remaining watchful for key signposts, management teams can prepare for a range of outcomes ahead of relevant government decisions.