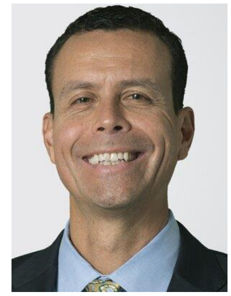
How To Manage During A Trade Dispute With USMCA Partners

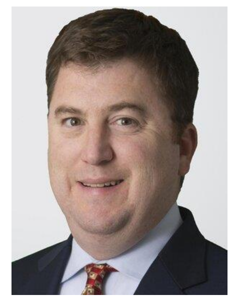
By **Peter Tabor, Molly O’Casey and Andrew McAllister** (January 7, 2025)

On Nov. 25, President-elect Donald Trump announced he would impose 25% tariffs on Mexico and Canada.[1] He has not yet indicated which authority he would use, however, a president has wide discretion to impose tariffs.



Peter Tabor

Trump previously used tariff threats as leverage when negotiating free trade agreements. Therefore, the announcement is likely related to the renegotiation of the U.S.-Mexico-Canada Agreement, or USMCA, scheduled for 2026. Given the interdependence of the three countries' supply chains and the likelihood of retaliatory tariffs, companies should be prepared to implement creative tariff solutions if tariffs are imposed.



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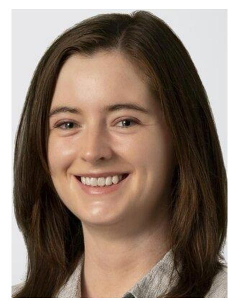
Trump's Tariff Threats Against Canada and Mexico

Trump indicated via Truth Social that these tariffs would be included in executive orders issued on Jan. 20, the date of his inauguration. Trump's posts further indicated that the tariffs will remain in place until Mexico and Canada address the movement of drugs and migrants across the U.S. border.



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These tariffs, if imposed, would have a significant impact on trade relations with the largest U.S. trading partners. Per the U.S. Census Bureau, imports of goods to the U.S. from Mexico totaled $475.2 billion in 2023, an increase of 5.1%, or $23.2 billion, from 2022. Imports of goods to the U.S. from Canada totaled $418.6 billion in 2023, a decrease of 4.3%, or $18.8 billion, from 2022.

During Trump's first administration, he used tariffs to punish perceived bad actors and seek concessions from trading partners. He imposed nearly $80 billion in tariffs on around $380 billion in imports during his four years in office, relying on Sections 201 (solar panels, washing machines) and 301 (Chinese imports) of the Trade Act, along with Section 232 of the Trade Expansion Act (steel and aluminum).

While Trump was able to secure concessions from U.S. trading partners, the nation's trade deficit rose during his four years in office.[2]

Trump may once again rely on Sections 201, 301 and 232 to impose tariffs on Canada and Mexico. However, he has expressed frustration with the procedural requirements — and delay — attached to these provisions. Consequently, Trump has suggested that he will rely on other provisions, ones that do not require a federal agency investigation as a prerequisite to imposing tariffs.

Based on comments from Trump and his team, these may include the International Emergency Powers Act, Section 338 of the Tariff Act of 1930, and Section 122 of the Tariff Act of 1974. However, the legality of imposing tariffs pursuant to these provisions is unclear. These provisions have either never been used, or not been used recently, to impose tariffs.

In the short term, certain U.S. industries may welcome the protection from international competition that tariffs provide. However, U.S. companies will also face uncertainty if trading partners impose retaliatory tariffs, which will disrupt international supply chains. Consumers will also suffer the effects of higher costs for a wide range of products.

Dispute Resolution and USMCA Review

Trump's announcement of additional tariffs on Mexico and Canada occurs against the backdrop of the USMCA. The USMCA came into force in 2020 and is the Trump-negotiated replacement of the North America Free Trade Agreement.

The USMCA continued free trade between the U.S., Mexico and Canada, and prohibits the imposition of tariffs on other parties outside of those provided for in the agreement. The imposition of additional tariffs by the U.S. on Mexico and Canada may be an apparent violation of the USMCA. However, the USMCA provides for broad exceptions. Therefore, Mexico and Canada may find it challenging to resolve a disagreement over tariffs through dispute resolution.

The USMCA Exceptions

The USMCA includes exceptions relating to essential security and balance of payments.

Article 32.2 allows a party to apply measures that it considers "necessary for the fulfilment of its obligation with respect to maintenance or restoration of international peace or security, or the protection of its own essential security interests."

The scope of the USMCA's security exception is broader than the equivalent in Article 2102 of NAFTA. Unlike NAFTA's national security exception, Article 32.2 does not require that actions to protect essential security be "taken in time of war or other emergency in international relations".

As both Section 232 and the IEEPA identify national security as a justification for tariffs, the U.S. may argue that these tariffs are permitted under the USMCA under the essential security exception.

Article 32.4 of the USMCA allows parties to adopt or maintain "a restrictive measure with regard to payments or transfers for current account transactions in the event of serious balance of payments and external financial difficulties or threats thereto," or for restrictions on capital movements in similar circumstances.

The balance-of-payments justification for tariffs is specifically provided for in Section 122, which allows the president to impose new tariffs of up to 15% on imports for 150 days. Per the Census Bureau, in 2023, the U.S. trade deficit was $152 billion with Mexico and $64 billion with Canada.

Given the U.S. government's position that it has broad discretion to impose tariffs for reasons of national security, and the latitude of the USMCA's essential-security exception, Canada and Mexico may find it difficult to challenge any U.S. tariffs.

Apparent Violation of the USMCA

Mexico and Canada could seek a remedy via the USMCA dispute settlement mechanism. An ad hoc arbitration panel, drawn from an agreed-upon roster, would have five months to review the dispute and issue a report.

The report would include recommendations for resolving the dispute — if the disputing parties have jointly requested them — but the parties are not bound to follow these recommendations.

After receiving the report, the parties have 45 days to resolve the dispute. If a resolution is not reached within 45 days, the complaining party may suspend benefits to the responding party, to the extent that the suspension has an effect equivalent to the measure or conduct found to be in violation of the USMCA.

If the responding party believes that the suspension of benefits is excessive or that it has cured the violation, it may request that the panel consider the issue. If the panel concludes that the suspension is excessive, it must recommend a level of benefits that it considers to be of equivalent effect. If the panel finds that the violation has not been cured, then the complaining party may suspend benefits up to the level determined by the panel.

USMCA Review

The USMCA contains specific review and renewal provisions. Under USMCA Article 34.7, the parties must review the agreement every six years and either (1) renew for another 16 years, (2) negotiate and agree to revisions associated with a renewal, or (3) fail to renew, which triggers a subsequent annual review by the parties.

All three countries are preparing for the review in 2026. U.S. stakeholders are encouraged to identify priorities for review, and ensure these priorities are conveyed to U.S. government officials in advance.

The parties can amend the agreement under Article 34.4 or withdraw from it under Article 34.6, with six months advance written notice to the other parties. Though Trump is unlikely to withdraw from an agreement he lauded as a vast improvement over NAFTA, it is likely he will seek to amend the agreement through the review process.

In the U.S., the review process is governed by the USMCA's implementing legislation. The executive branch — the president and the U.S. trade representative — represents the U.S. in the joint review process. The USTR will seek stakeholder and public input this year, and report its joint-review recommendations to Congress by the end of December.

The parties must deliver their recommendations to each other no later than one month before the joint review date, July 1, 2026.

Congressional Action

Congress will play a role in the USMCA review, and could also seek to rein in Trump's power to impose tariffs. The U.S. Senate must decide whether to confirm Howard Lutnick and Jamieson Greer, Trump's respective picks to lead the U.S. Department of Commerce and serve as the USTR. Both will play central roles in the USMCA review.

Congress must also determine what role it seeks in U.S. trade policy. On Nov. 20, Democrats introduced the Prevent Tariff Abuse Act, which would prevent the president from bypassing Congress when implementing broad tariffs.[3]

Though the bill's future is uncertain, some Republicans, wary of retaliation provoked by the proposed tariffs, may be interested in regaining some measure of control over trade policy, which the legislative branch has ceded to the president over the past several decades.

Though Republicans will control both chambers of the 119th Congress, its members are divided between a more populist wing that supports increased tariffs and a more traditionally conservative wing that is skeptical of their economic effects. As a result, the next Congress is likely to limit its oversight and critiques of the proposed tariffs to side conversations with the administration rather than oppose or criticize directly.

Reactions From Canada and Mexico

During the first Trump administration, Canada and Mexico responded to Trump's tariffs with their own tariffs on U.S. exports, targeting U.S. agricultural products. With the signing of the USMCA, the three trading partners created an import-monitoring mechanism for steel and aluminum. In turn, Canada and Mexico lifted their retaliatory tariffs in May 2019.

As noted above, Canada and Mexico have indicated they would retaliate with tariffs against U.S. exports if Trump follows through on his campaign pledge and recent announcement to impose tariffs on their exports.

Mexican President Claudia Sheinbaum, in a November letter to Trump, conveyed that Mexico will respond in kind if the U.S. imposes tariffs on Mexican exports. Canadian Prime Minister Justin Trudeau made a similar statement.

However, the Canadian response is in doubt following Trudeau's Jan. 6 announcement that he intends to resign in March, which followed Canadian Finance Minister Chrystia Freeland's announcement that she too will resign. Freeland had cited differences with Trudeau over how to counter the incoming U.S. administration's aggressive trade strategy as the reason for her resignation.

Taking cues from the tariff wars during Trump's first term, we can expect retaliation to target specific sectors — including agriculture, energy, minerals and transportation — that rely on either exports or inputs from North American trading partners.

Depending on the mechanism Trump uses to impose these tariffs, trading partners and U.S. stakeholders should identify and use any and all opportunities to engage with the federal government in advance of negotiations that could have a great impact on them.

What Companies Should Do

Manufacturers should review their supply chains to assess their vulnerability to tariffs on imports from, as well as exports to, Canada and Mexico. In engaging the Trump administration on trade matters, companies should evaluate the impact of certain policies on important consumer products.

In particular, companies that rely on imports should advocate for exemptions to tariffs and the recognition of their interests in the renegotiation of the USMCA. Those that rely on exports should identify ways to minimize the effects of retaliatory tariffs. Foreign companies should work with their U.S. partners to identify and protect vulnerabilities in supply chains, and advocate for exemptions.

Tariffs essentially function as a tax on imports. The increased costs are spread through the supply chain and frequently passed on to consumers. Once consumers adjust to those prices, businesses tend not to lower them, even after inflationary pressures recede.

According to a study published in October by the Tax Policy Center, the economies of U.S. states in the Midwest and the South are the most reliant on imports.[4] Heavily integrated supply chains among the U.S., Canada and Mexico produce goods such as automobiles, electronics, plastic products, medical equipment, energy, machinery, agricultural products, and steel and aluminum products. These industries and their workers would be the most affected by tariffs, including retaliatory tariffs.

In the short term, companies should consider stockpiling goods at pretariff prices, prior to Trump's inauguration on Jan. 20. Companies should also develop messaging to key administration officials and policymakers that advocates for exemptions for their products, emphasizing the impact the tariffs will have on consumers and the economy.

In the long term, companies should look at options for diversifying their supply chains, with a focus on reducing reliance on single countries, including increasing domestic components and importing from other countries with which the U.S. has free trade agreements.

Companies should also identify the country of origin and the Harmonized Tariff Schedule classification of their products to ensure they are not paying higher tariffs unnecessarily.

Incorporating foreign trade zones and bonded warehouses to defer entry into the U.S. market can also be effective tools for managing the timing of tariff payments.

On a more technical level, the valuation methodology used to calculate tariffs should also be examined. Programs such as the first sale duty reduction program, in which importers declare the price paid for the first sale in the supply chain of a product destined for the U.S., can reduce tariff impacts.

Finally, companies should consider their international customer base and identify opportunities to apply for duty drawback when finished U.S. products that incorporate imported inputs are exported from the U.S.

The Trump administration's trade strategy for Canada and Mexico, the U.S.' largest and geographically closest trading partners, will be highly impactful across the U.S. economy. Accordingly, U.S. companies should exercise creativity in managing their supply chains.

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[1] https://truthsocial.com/@realDonaldTrump/posts/113546215051155542.

[2] https://www.bea.gov/news/2021/us-international-trade-goods-and-services-december-2020.

[3] https://www.congress.gov/bill/118th-congress/house-bill/10181.

[4] https://taxpolicycenter.org/taxvox/trumps-proposed-tariffs-would-fall-hardest-states-midwest-and-south.