

Intelligence MEMOS



As NAFTA renegotiations proceed through the fall C.D. Howe Institute Intelligence Memos will be looking at what to expect and provide analysis on the latest developments at the table. This post is part of that series.

From: Christopher Sands
To: Concerned Canadians
Date: October 31, 2017
Re: **PLAYING CHICKEN WITH CANADA, MEXICO AND THE NORTH AMERICAN AUTO INDUSTRY (PART TWO)**

Yesterday [we discussed](#) how the aggressive US proposals in round four of the NAFTA renegotiation would affect the North American auto industry.

Today, we explore the future.

Taken together, the US proposals (increased US content requirements and more aggressive parts traceability in particular) will severely limit the flexibility of the automakers to adapt to changes in the global market.

Consider that all automakers today are already coping with the emergence of [autonomous vehicle technology](#), the drive toward [low emission](#) and [electric](#) vehicles to meet climate change regulations, and the development of [3-D printing using metals](#) as well as plastics.

There are several options for firms to adjust, but governments may not like them: firms could drop unprofitable small vehicles that are more fuel efficient and make cars available for lower income households, or firms could accelerate the replacement of autoworkers with robots. If pressed, firms can resign themselves to failing to meet the new NAFTA rule of origin and [just pay the 2.5 percent tariff](#) (today's US rate under the most-favoured nation principle that charges all importers the same rate absent a trade agreement). But if a firm is going to pay 2.5 percent, why not simply import parts from low-cost locations like China?

Flexibility in automotive supply chains is not merely nice for assemblers, it is necessary if firms hope to survive in today's competitive global auto industry. As such, the US proposals for a renegotiated NAFTA pose an existential threat to automotive manufacturing in North America.

This is why the auto industry [rallied](#) after Round Four of the NAFTA talks to oppose the US proposals with remarkable unanimity.

There is a reason that the 1965 Auto Pact was one of the first trade liberalization agreements in North America. It is the same reason that automotive industry support was crucial to the successful ratification of the Canada-U.S. Free Trade Agreement and the first NAFTA. The auto industry is the heart of North American manufacturing. It is, as [Peter Drucker](#) said, "the industry of industries" and employs hundreds of thousands of Americans, Canadians and Mexicans directly and indirectly. NAFTA helped to bring Japanese, Korean and German assemblers to locate production in North America.

If the North American automotive industry opposes the new NAFTA, it will fail. Auto firms are adept in mobilizing their employees, their suppliers, and engaging their unions in political activity. The US Congress will need to pass new legislation to enact a new NAFTA in the United States, and can act to prevent a US NAFTA withdrawal from having any effect by blocking rulemaking that would undo existing NAFTA provisions. If President Donald Trump uses NAFTA to threaten the survival of the auto industry, the auto industry can and will frustrate attempts to get a majority in Congress to approve Trump's changes.

This suggests that the United States proposals are primarily intended to shock and awe the auto sector as well as Canadian and Mexican negotiators and get them to think creatively about how far they can go toward the US proposals. In the weeks ahead, government and firms will run the numbers on various combinations of the US proposals and find potential compromises. An increase in the automotive rule of origin is likely, but the time allowed for transition, practices such as substantial transformation and limited traceability, and domestic content requirements will be in play.

Like the game of chicken played by two drivers accelerating toward each other, the question is who will swerve first to avoid a crash. If nobody swerves, nobody wins. Mr. Trump surely prefers to be a winner; expect U.S. negotiators to maneuver to avoid an automotive collision over NAFTA.

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