Volume 32 | Issue 19 | October 15th, 2018

OBSERVATIONS

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The Village People

OK everybody let’s sing along:
“It’s fun to stay at the Y.M.C.A
It’s fun to stay at the Y.M.C.A
They have everything for you men to enjoy
You can hang out with all the boys
It’s fun to stay at the Y.M.C.A
It’s fun to stay at the Y.M.C.A”

Oops, sorry I have the wrong song:
“ It’s good to have the U.S.M.C.A.
It’s good to have the U.S.M.C.A.
It has everything for each politician to brag about
You can hang out with Mexicans and Americans
It’s good to have the U.S.M.C.A.
It’s good to have the U.S.M.C.A.”

It is nearly official; Canada, Mexico and the United States have renegotiated “the worst Trade Agreement in the history of the world” and it seems that once each jurisdiction has passed enabling legislation we will now have “the best Trade Agreement in the history of the world”. Trade Agreements are incredibly important but I disagree with each of these statements. The Trade Agreements that shaped the automotive sector resulted in significant opportunity for each country. It is indeed good to have this new Agreement but there are terms related to the automotive sector that could result in some disruption within the sector. But I also have to admit the alternative of a 25 percent tariff was the ‘nightmare’ scenario so we all should breathe a sigh of relief. A quick review of automotive related Trade Agreements shows just how important they have been in shaping our industry.

When the Autopact was signed on January 16th, 1965 sales of new vehicles in North America (Canada, Mexico and the U.S.) were about a little less than 12 million units with a similar number of used vehicles being sold, production was also about 12 million units which meant that other than a few VW Beetles there were very few imports. In addition there were about 90 million light vehicles on the road and they were driven about 1.6 trillion kilometres each year.

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VEHICLE USAGE TRENDS - NORTH AMERICA

CALENDAR YEAR	VEHICLE USAGE BILLIONS OF KILOMETRES	TOTAL UNITS IN OPERATION	VEHICLES PER DRIVING AGE POPULATION
1960	1,280	74,468,295	47.8%
1965-AutoPact	1,590	89,976,344	52.7%
1989-FTA	3,908	199,047,962	75.6%
1994-NAFTA	4,395	213,879,308	75.5%
2000	5,172	228,828,594	74.0%
2010	5,725	274,812,678	77.5%
2015	6,126	292,589,413	78.3%
2016	6,352	295,592,536	78.8%
2017	6,595	298,395,160	78.3%

Vehicles per driving age population was just over 50 percent.

With the signing of the FTA in 1989, new vehicle sales in North America had risen to about 17 million per year, used vehicle sales were over 25 million units and production was 13.5 million units per year which meant that imports from overseas accounted for a little over 20 percent of the market. The number of vehicles on the road was over 200 million units and they were driven 3.9 trillion kilometres per year. Ownership of vehicles had grown to over 70 percent of the driving age population.

The NAFTA agreement signed in 1994 expanded the FTA to include Mexico and 23 years later (2017) sales of new vehicles are above 21 million units per year, sales of used vehicles are north of 40 million vehicles per year and production is about 17 million units per year so import penetration from overseas is now approximately 20 percent of the market. The number of vehicles on the road is approaching 300 million and they are driven almost 7 trillion kilometres per year. Ownership has risen close to 80 percent of the driving age population.

The automotive sector has grown radically since 1965 and personal use transportation has become much more important and integrated into our lifestyle. There was much more involved in facilitating this explosion of economic activity than just Trade Agreements . Population growth, urban sprawl, higher quality vehicles that now last 20 plus years, global competition for the consumer’s automotive dollars were also all a part of this as well but I would still argue that these Trade Agreement were critical elements.

What they did was force the automotive sector to become highly efficient and take billions and billions of dollars in cost out of the sector. Adjusting for content and the change in the types of vehicles consumers prefer, the inflation adjusted price of a vehicle has moved very little over the last few decades. It is hard to quantify, but my estimate is that price inflation for new vehicles is under one percent per year. It might be more than this but it is definitely less than the inflation rate for all goods in the economy. Whenever ‘any’ good becomes not only less expensive but more technologically advanced and higher quality, consumers tend to buy more not less.

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Using Canadian numbers there are now somewhere between 750,000 and 850,000 individuals "directly" employed in the Canadian automotive sector value chain starting with materials, then tool, mould and die, components, vehicle assembly, vehicle distribution, vehicle retail both new and used, financing of vehicles, vehicle maintenance, and vehicle disposal. I don't know how many were employed in 1965 but it would have been a third or less than this. It is absolutely true that one in seven jobs in Canada are dependent directly and indirectly on the automotive sector. A similar analysis was conducted during the financial crisis on the importance of the automotive sector in the U.S. and it came up with results similar to the Canadian numbers. I've never seen this analysis for Mexico but their industry is much larger than the Canadian industry so the automotive sector is obviously very important to Mexico as well.

This is also why I feel that the U.S. Administration made a serious tactical error in threatening a 25 percent tariff on vehicles and parts if Mexico and Canada did not capitulate to some of their demands. Every analysis I read from Canadian but also American and Mexican analysts clearly indicated that this tariff would be more harmful to the United States than it would be to Canada or Mexico. As odd as it may seem there is actually more U.S. labour content in a vehicle manufactured in Canada than Canadian labour content.
Yes, Canadians assemble the vehicles but assembly labour accounts for only 5 to 8 percent of the cost of producing a vehicle. Component labour accounts for upwards of 30 percent of the cost of a vehicle and most of this content comes from American suppliers. So for every Canadian auto worker that lost their job at least 2 American auto workers would have been impacted as well. In addition, if all vehicles imported into the US faced this tariff then U.S. consumers would have to pay an additional $3 to $10K for their vehicles. That is serious punishment levied onto American consumers to score political points.

So at the end of the day it was a political threat from an administration that does not fully understand the economics of the automotive sector rather than an economic threat. The negotiators from all three countries would have known this and thus it appears to analysts like myself that there was more theatre over the last year plus than substance in the final Agreement. I can only talk to the automotive terms of the Agreement.

First, Canada will face a cap of an additional 900,000 vehicles that it can export to the U.S. We currently export about 1.7 million and will not be allowed to export more than 2.6 million before duties are applied. To export an additional 900K vehicles would take at least three new greenfield assembly plants and possibly four new plants. Canada hasn't attracted a new assembly plant for more than a decade so the probability of ever running up against this quota is near zero.

Second, a high proportion of content will have to come from workers making at least $16.00

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per hour. This is clearly targeted at Mexico and should have no negative impact on Canada. Indeed an argument can be made that, on the margin, some Canadian suppliers might be more competitive to Mexican suppliers once these higher wages kick in.

Third, North American content of vehicles will have to be above 75 percent instead of the current 62.5 percent. This clause is targeted at off-shore component imports that have risen substantially over the years. Most, but not all current vehicles would qualify so there should be some opportunity for North American suppliers to benefit from this clause.

Fourth, there will be a more intense tracking system put in place to actually calculate the country of origin for components used to manufacture a vehicle in North America. This was probably needed as vehicles have become so complex that gaming of the content rules was becoming an issue.
Every auto sector executive I've heard comment on this Agreement has come out in favour of the deal. And everyone, including myself, agrees that getting rid of NAFTA and/or imposing a 25 percent tariff would have been devastating to the industry so I, like everyone else, am in favour of the Agreement. But there are concerns that should not be ignored.

Remember that the explosion in economic activity tied to the automotive sector was primarily tied to the efficiencies that the automotive sector accomplished due to all the factors mentioned earlier. At least three of the terms agreed to could erode some of these efficiencies and or increase costs. The $16.00 dollar wage certainly increases cost, content requirements are protectionist and the higher the content the more protectionist they become and with it comes less efficiency. Yes some of that higher content may be picked from suppliers in North America (including Canada) but at what cost? And the paper work required with the new tracking system will be much more onerous than what is currently required.

We don't know how much these inefficiencies will affect the price of a vehicle. But we now buy 21 million new units per year instead of the 12 million units in 1965 because the cost of a vehicle in real terms is so low. Costs per vehicle resulting from the U.S.M.C.A. will increase and these will be passed onto the consumer. And when costs go up consumers buy less, not more. The automotive sector still may end up net positive once all of these changes work their way through the value chain but they may be a lot less positive than some would speculate.

At the end of the day the real benefit of this Agreement remained avoiding the 25 percent tariff and/or the cancelling of the entire NAFTA Agreement. A lot of water needs to flow under the bridge before we know whether the new Agreement is net positive or net negative for the North American automotive sector. **DAR**

October 15th, 2018 | ISSN 0841-9957