January 2019

North America's New Free Trade Agreement: Impacts on the North American Auto Sector

By Greg Keenan[1]

A co-publication of the Wilson Center's Canada Institute and Mexico Institute

Executive Summary

The new North American free trade agreement will have a substantial impact on vehicle manufacturers, their parts suppliers and their customers. The impact on vehicle companies will vary depending in part on where such key components as engines and transmissions are sourced for their North American assembly plants.

Changes in the rules of origin that require higher amounts of North American-generated content will increase production costs. These will be passed on to consumers in the three countries or absorbed by the car companies, reducing the competitiveness and profitability of the North American auto industry, but supply chains that have been built up over almost a quarter-century of NAFTA will remain largely intact.

---

1 Greg Keenan reported on automotive issues for the *Globe and Mail* from 1995 to 2018. He is a graduate of the *University of Toronto* and of the *University of Western Ontario School of Journalism*.

OVERVIEW

For the auto industry in North America, the USMCA[2] averts a potential disaster. The tearing up of the North American free trade agreement, which was threatened by President Donald Trump before and during the negotiations of a replacement pact, would have devastated an economic engine that has organized itself around continental free trade since NAFTA took effect in 1994.

The imposition of 25 percent tariffs on vehicles made in Canada and Mexico and exported to the United States—another threat made during the talks—would have wreaked havoc on auto jobs in all three countries and sent prices for vehicles soaring. [3]

For vehicle manufacturers and parts makers, therefore, the survival and continuation of the basic elements of NAFTA represent the most important outcome of talks that concluded September 30, 2018. The new agreement permits tariff-free shipment—for the most part—of vehicles and parts made in each of the three countries to continue within the trade zone. The relatively seamless supply chain network will not be severely disrupted. Investment in North America will continue.

The new agreement also reflects how the industry has changed since 1994, by taking into account the sweeping transformation occurring in the sector as car companies and their suppliers spend billions researching and developing new propulsion systems and autonomous vehicles.

There are, however, some significant changes, notably in rules of origin for

---

2 The new North American free trade agreement, currently in various stages of legal approval by the signatories, United States, Canada and Mexico, has a different name in each of the three countries: USMCA (United States-Mexico-Canada Agreement); CUSMA (Canada-United States-Mexico Agreement); and T-MEC (*Tratado entre México, Estados Unidos y Canadá*). For the sake of simplicity, we will call it USMCA here.

3 Sherman Robinson, Karen Thierfelder, Jeffrey J. Schott, Euijin Jung and Zhiyao (Lucy) Lu, "Trump's Proposed Auto Tariffs Would Throw US Automakers and Workers Under the Bus," *PPIE*, (May 31, 2018).

finished vehicles and the introduction of labor-value content requirements, that are expected to raise costs. Some shifts in jobs and investment have already occurred even before the deal is ratified in the three countries. As well, import tariffs of 25 percent on steel and 10 percent on aluminum levied by the United States on Canada, Mexico and other countries remain in place despite the agreement, raising costs for all vehicle producers in North America.

PROVISIONS OF THE DEAL[4]

Regional Value Content

The new agreement changes the rules of origin for vehicles made in the three countries, raising the threshold for the amount of North American content required for duty-free access. By 2023, vehicles assembled in any of the three countries must contain 75 percent North American regional content, up from 62.5 percent in NAFTA. The new requirements will be phased in between 2020 and 2023.[5]

Also, while origin can generally be determined as a percentage of the total value of the vehicle, some exceptional parts, such as engines and drive axles, must meet an individual origin threshold, rising from the current 62.5 percent to 75 percent by 2023.

Labor-Value Content

The USMCA also phases in new rules to encourage high-wage production, so that by 2023, 40 percent of the labor content in a passenger vehicle must come from regions where wages are a minimum of $16 an hour.[6] For light trucks, 30 percent of the labor content must come from such high-wage regions. The percentage figures include assembly and spending on research and

---

4 Office of the United States Trade Representative (USTR), "United States-Mexico-Canada Agreement," *Office of the United States Trade Representative (USTR)*, (November 30, 2018).

5 The requirements are effective in those years if the agreement is ratified by all three countries and in place by 2020.

6 All figures in this report are in US dollars unless indicated.

development and information technology, a nod to new-generation vehicles such as hybrids, battery electric vehicles and autonomous cars and trucks.

Table 1: USMCA Value Content Provisions		
Regional Value Content		
Light Vehicles	75%	3-year transition, but automakers can appeal for a 2-year extension for a limited amount of production (~10%) if they have a "credible plan" to meet the new ROO.
Core Parts	75%	Includes engine, transmission, body & chassis, axle, suspension, steering (all 3-year transition), and advanced batteries (5-year transition). Must be originating for the vehicle to be originating.
Principal Parts	70%	Includes tires, glass, pumps & compressors, A/C, bearings & bearing housings, electric motors used as primary source of propulsion, electric motors for electrical variable transmission, electromagnets, starter motors & generators, bumpers, safety belts, brakes, road wheels, radiators, mufflers, clutches, airbags, seats and parts of seats.
Complementary Parts	65%	Includes pipes, catalytic converters, valves, taps & cocks, electric motors and universal AC/DC motors not exceeding 37.5W, DC motors and generators not exceeding 750W, other batteries, distributors & coils, electrical lighting, windshield wipers/defrosters, sound recording/reproducing apparatus, switches, insulating wiring sets, headlamps, electronic instruments & measurement equipment.
Steel & Aluminum	70%	Day 1 rule, no transition.
Labor Value Content		
Overall		Hourly wage (production/trades/temps) above $16USD/hour. Can average within one country across class, model, or plant. Up to 10% credit for R&D and IT content, up to 5% credit for assembly in high-wage region.
Passenger Cars	40%	At least 25% from materials & manufacturing content.
Pickup Trucks & Cargo Vehicles	45%	At least 30% from materials & manufacturing content.

232
Up to 2.6 million passenger vehicles/year from each Canada and Mexico, an unlimited number of light trucks, and $32.4B USD (Canada) and $108B USD (Mexico) in parts will be exempt from any U.S-imposed Section 232 tariff on imported vehicles or parts.
The parties will continue to negotiate to remove existing Section 232 tariffs on U.S. imported steel & aluminum; 10% aluminum and 25% steel tariffs remain in effect.
Canada and Mexico will have a 60-day period to negotiate an outcome if the U.S. chooses to impose Section 232 tariffs on any other goods and services.
MFN
Mexico ONLY - 1.6 million units of non-conforming production will be subject to existing MFN rates (2.5% on cars and parts, 25% on trucks and cargo vehicles) if the U.S. raises overall auto and parts MFN rates.
Wages
U.S. and Canadian assembly and parts wages above $20.
Mexican assembly wages $7.34, parts wages $3.41.

Source: Center for Automotive Research, (October 2018).

Local Content

Another requirement that did not exist under the original NAFTA is that vehicle producers must now purchase 70 percent of their steel and aluminum in North America, even though such local content provisions are generally prohibited by the WTO.

Section 232 Tariffs and Side Letters

During the negotiations, the Trump administration threatened to impose tariffs on vehicles imported from Canada and Mexico using the national security provisions of section 232 of the 1962 Trade Expansion Act. The United States did not agree to remove that threat in the final USMCA agreement, but the text includes side letters with each of those countries that would mitigate such an action.[7]

If section 232 tariffs were imposed on Canada, the side letters affirm that up to 2.6 million Canadian-made passenger vehicles, all light trucks made in Canada, and up to $32.4 billion worth of auto parts would be excluded annually.

7 Office of the United States Trade Representative (USTR), "United States-Mexico-Canada Agreement: Section 232 side letters: Canada and Mexico," *Office of the United States Trade Representative (USTR)*, November 30, 2018.

Similarly, Mexico's side letters affirm that 2.6 million vehicles would be excluded from the tariff, as would U.S. imports of auto parts up to a value of $108 billion.

The deal includes other side letters that provide 60 days of negotiations before tariffs under section 232 are levied by the United States on any products from Mexico or Canada.

Light Trucks

The agreement maintains the U.S. tariff of 25 percent on pickup trucks imported from outside North America while retaining duty-free shipment within the trade zone if the new rules of origin are met. Although this keeps the status quo in place, it's a significant positive development for Mexico, because pickup truck production represented almost one-quarter of the country's total light vehicle output in 2017, the lion's share of which were exported to the United States.

If NAFTA had been terminated, the imposition of a 25 percent U.S. tariff on those vehicles could have led to the end of pickup truck production in Mexico.

Shifting Jobs and Investment to the United States

Outside of the legal provisions of the deal, the President successfully shifted automotive production and investment to the United States (and primarily away from Mexico) through continued hectoring of individual automakers. Consequently, significant shifts in assembly plant investment intentions had already occurred before the NAFTA renegotiations began in August 2017. Those changes were made because of the possibility that the United States might withdraw from NAFTA and after President Trump threatened some auto makers using his Twitter account.

Ford Motor Co., for example, scrapped plans to spend $1.6 billion to build a new small car plant and create 2,500 jobs in San Luis Potosi, Mexico—a move made just days before Mr. Trump took office on January 20, 2017. Ford had been a regular target of Mr. Trump during the 2016 presidential campaign.

That same month, via Twitter, the President notified Toyota Motor Corp. that the company's intention to build a $1-billion assembly plant in Guanajuato, Mexico, had caught his attention. "Build plant in U.S. or pay big border tax," he warned.

Seven months later, Toyota announced a $1.6 billion investment to build a joint venture plant with Mazda Motor Corp. in Alabama and scaled back its Mexico investment. The Alabama facility will likely provide 4,000 jobs by 2021.

In January, 2018, as the trade negotiations were stalled over the initial U.S. auto proposals, Fiat Chrysler Automobiles NV announced it would shift production of heavy duty pickups out of a plant in Saltillo, Mexico, to a factory in Warren, Mich., and hire 2,500 people. That's a $1 billion investment.

ASSESSMENT OF THE DEAL

Any evaluation of the potential effects of the agreement on the auto industry must acknowledge how damaging the total elimination of the NAFTA could have been to industry, weighed against the likelihood that the President would have followed through on his threats to kill the agreement. By this measuring stick, an imperfect deal is better than no deal at all.

The new USMCA preserves the automotive ecosystem that developed under NAFTA, but the costs of assembling vehicles and making parts are expected to increase. In the short term, costs have already increased because of the section 232 National Security tariffs that were put in place during the negotiations.[8] Those tariffs have added an extra $400 to the cost of assembling a vehicle in the United States, says Matt Blunt, president of the American Automotive Policy Council.[9] "It's clearly undermined our competitiveness," Mr. Blunt said.

The chief financial officers of Fiat Chrysler and General Motors said on their companies' third-quarter financial results conference calls that increases in the prices of such commodities as steel and aluminum—in part because of the tariffs—will raise their costs by about $1 billion each in 2018.

GM has offered voluntary buyout agreements to 18,000 salaried workers as one method of trying to offset the rising costs. Higher costs also contributed to a recent GM decision to begin the process of closing two vehicle assembly plants in the United States and one in Canada.

Ford's chief executive Jim Hackett has said the tariffs will reduce profit by $1 billion. Honda Motor Co. Ltd. has identified hundreds of millions of dollars in cost increases.

---

8 Board of Governors of the Federal Reserve System, "Federal Reserve Bank of Boston," *Board of Governors of the Federal Reserve System*, (October 24, 2018).
9 Washington International Trade Organization (WITA), "10/18/2018 USCMA: What's New in NAFTA 2.0? | Part 1 (minutes 14:22-14:34)," *Washington International Trade Organization (WITA)*, (October 18, 2018).

Labor dislocation

Under pressure from U.S. and Canadian negotiators, Mexico agreed to change its labor laws so that they recognize the rights of workers to collective bargaining. This could eventually lead to increased unionization in the auto sector in Mexico and therefore higher wages.

The $16 an hour wage provisions in the agreement will be a significant challenge for Mexico. At present, wages in the auto parts sector in Mexico are the equivalent of about $3.41 an hour and assembly plant wages are about $7.34 an hour, compared to $20.00+ an hour wages in the United States and Canadian parts plants.[10]

Ildefonso Guajardo, Mexico's former Economy Minister in 2018, estimated that about 70 percent of Mexican vehicle production would be able to comply with the new labor value content rules "with some effort from here to the 1st of January, 2020."[11]

But, to some extent, the new USMCA labor provisions will not raise Mexican wages as much as they will shift production northward and into higher value-added functions, more often performed in the United States and Canada. This is because the labor content provisions will give credit for spending done in North America on research and development. This is a significant modernization from original 1994 NAFTA, which took effect when there were no hybrid or electric vehicles on the road and autonomous vehicles were a pipe dream.

That's an advantage to the Detroit Three car companies—Ford and GM in particular—over their Asia and Europe-based competitors because the vast majority of the R&D work performed by the Detroit Three is done in North America, while their competitors concentrate R&D in their Asian and European headquarters.

But, despite some competitive advantages generated by credits for North American R&D, the sector as a whole is likely to become less competitive globally because of the added costs of a more complex deal. The need to correlate labor spending with production output and shift certain activities to

---

10 Kirstin Dziczek, Michael Schultz, Bernard Swiecki, and Yen Chen, "NAFTA Briefing: Review of current NAFTA proposals and potential impacts on the North American automotive industry," Center for Automotive Research, (April 2018), 4.

11 Bloomberg Markets, "Mexico's Guajardo Says Will Engage om Trilateral Nafta Talks," *Bloomberg Markets*, (August 28, 2018).

high-wage regions means that all auto companies operating in North America will face increased costs, compared to non-North American competitors, as they try to adhere to the new agreement.

Local-content provisions

The requirement that 70 percent of the steel and aluminum car companies use in their vehicles come from North America will also raise administrative costs. Steel bought from steel service centers and steel used by suppliers must also meet the North American origin threshold, thus, car companies and parts makers will face the adding costs of tracking those sources of steel.

Side letters are a band-aid, not a solution

The side letters on section 232 give auto companies now assembling vehicles in Mexico some wiggle room to sidestep the USMCA and export to the U.S. market using the 2.5 percent most favored nation tariff instead. The production thresholds under which preferential treatment is permitted are unlikely to be exceeded if historic production trends hold. Mexico exported 2.44 million vehicles to the United States in 2017, less than the new export ceiling of 2.6 million and Canadian exports of 1.8 million vehicles to the U.S. market last year were well below the threshold where section 232 tariffs would take effect.

What is more complicated for Mexico is that their side letter requires them to develop methods for determining how the overall 2.6 million threshold applies to individual companies. The ability (or the requirement) to favor one company over another is certain to generate political and competitive tensions.

What's not clear from the agreement is how section 232 tariffs would be applied if exports from Mexico exceed 2.6 million vehicles. If, for example, one car company increases its exports to the United States dramatically and pushes total Mexico exports over the 2.6 million limit, while another company's exports have fallen, will vehicle exports from both manufacturers be subject to the 232 tariff?

WHAT IT ALL MEANS

Higher costs for North American producers and consumers

The 75 percent regional value content, 70 percent local content requirement for steel and aluminum, together with the minimum wage/labor-value content clauses are designed to create more automotive jobs in the United States amid the perception from Mr. Trump that automotive investment and jobs had been

migrating out of that country and to Mexico because of NAFTA.

Part of that perception is true. Investment from vehicle companies has been flooding into Mexico since NAFTA began, but assembly plants operated by Asia and Europe-based car companies have opened in several southern states during that same period. Every major global auto company that assembles vehicles in Mexico also operates assembly plants in the United States.

But attempting to pull jobs back into the United States has consequences. Costs of compliance with the more complex agreement will be passed on to consumers and higher local content rules limit manufacturers' ability to source from low-cost areas.[12] Any significant increases in costs will hinder the ability of auto manufacturers to export to markets outside North America.

Investment slows down

The USMCA is likely to lead to at least a short-term pause in investment in new assembly plants in Mexico as car companies assess the impact of the new rules of origin and labor content rules and determine how to meet them. The fact that the U.S. has hit a plateau at 17 million units of sales for three straight years and is starting to decline is another reason for any investment pause.

Variable impacts on OEMs[13]

A high percentage of the vehicles made by the Detroit Three in Mexico will meet the new rules because their North American content already exceeds 75 percent. Engines and transmissions—among the highest-content components—for many of those vehicles are made in the United States. Continuing that sourcing pattern will also help those companies meet the 40 percent high-wage labor content stipulation, but some Asia and Europe-based manufacturers will have a more difficult time meeting the new rules. Engines and transmissions for their vehicles, which make up about 30 percent of the content of a vehicle, tend to be shipped to Mexican plants from outside North America.

Example 1 – Honda Fit and CRV

Japan-based Honda Motor Co. Ltd., for example, assembles Fit subcompact cars and HR-V crossover utility vehicles in Celaya, Mexico. Fit models contain about

---

12 AutoForecast Solutions Global Outlook, "Auto Forecast Monthly: October 2018," AutoForecast *Solutions Global Outlook* (October 1, 2018), 5.

13 Original Equipment Manufacturers, including the Detroit Three, Honda, Toyota, etc.

65 percent North American content, while HR-Vs contain about 50 percent or 55 percent North American content depending on the model.[14] A main reason why these vehicles do not meet the 75 percent North American content threshold is because engines for both vehicles are shipped to Mexico from Japan, although transmissions for some models are made in Mexico.

Because they do not meet 75% regional content, Honda could continue to assemble the vehicles in Mexico but ship them to the United States using the most-favored nation tariff of 2.5 percent instead of trying to qualify under USMCA rules. Fit, however, is a low profit margin vehicle in a declining U.S. market segment, so a 2.5 percent tariff makes it less competitive. HR-V, is a subcompact crossover, which is a booming segment that commands higher prices, so the 2.5 percent MFN tariff is less burdensome.

Honda could shift Fit production back to Japan and devote the entire Celaya plant to HR-V output or the company could decide to discontinue selling the subcompact Fit in a U.S. market in which low gas prices have throttled back demand for such vehicles.

Or, it could reconfigure engine output in North America and ship U.S. or Canadian-made engines to Mexico, improving both its North American content numbers and its labor value content percentage.

Example 2 - BMW

Germany-based BMW AG faces a different situation at its Spartanburg, S.C. plant, which makes its X series of crossovers. North American content in the vehicles ranges from 60 percent to 75 percent with transmissions coming from Germany and engines from Germany and Austria. If BMW does not raise its North American content in those vehicles to USMCA levels, it could be subject to Canada's 6.1 percent tariff on vehicles that do not meet the new requirements.

BMW will begin production in Mexico this year of its 3-series passenger cars, which were its best-selling model in the U.S. market in 2018.

To meet the parts and labor content requirements, BMW could build a battery plant in the United States to supply batteries for hybrid versions of its U.S. and

---

14 National Highway Traffic Safety Administration (NHTSA), "AALA 2018," *National Highway Traffic Safety Administration*, (June 26, 2018).
Content figures are from the American Automobile Labelling Act. Content is calculated differently under NAFTA, but these numbers are a close approximation of actual content.

Mexico-made vehicles.

Senior executives of BMW and its key competitor Mercedes-Benz, said, in October 2018, that they were considering moving more manufacturing to North America because of the USMCA. Dieter Zetsche, chief executive officer of Daimler AG, which owns Mercedes, said it could shift some engine manufacturing to the United States, but no decision has yet been announced.[15]

A windfall for the North American parts industry?

Asia and Europe-based companies will likely have a higher need than their U.S. rivals to change the sources of some components, which would lead to increased investment and jobs in the United States and possibly in Canada.

Auto makers could insist that global suppliers shipping parts to their U.S. assembly plants from outside North America shift parts production to the United States or Canada to meet the new rules.

European companies could outsource production of transmissions to U.S. plants operated by ZF Friedrichshafen AG or award contracts to the Getrag division of Magna International Inc. for the manufacture of transmissions in the United States or Canada.

Any automaker whose North American content does not amount to 75 percent will face similar choices. Those choices could affect the selection of vehicles available to consumers and will have an impact on the prices of many vehicles.

"Conforming to the USMCA rules and strategic responses to avoid the risk of additional tariffs will raise production costs for light vehicles and automotive parts, driving up consumer prices."[16]

WHAT'S NEXT

The approximately two-year period from the election of Mr. Trump through the negotiations that began in August 2017 and the impending ratification of the USMCA needs to be treated in its entirety as an episode that has caused and will cause significant change in the auto industry in North America.

---

15 Chester Dawson and William Boston, "Auto Makers Consider Shifting More Manufacturing to North America," *Wall Street Journal*, (Oct. 5, 2018).

16 Center for Automotive Research (CAR), "Meet the New NAFTA," *Center for Automotive Research (CAR)*, (October 2018).

While the industry has been spared the major upheaval that would have been caused by the end of North American free trade, it is not entirely out of the woods. The United States is holding separate negotiations with Europe and Japan and has threatened to impose 25 percent tariffs on European and Japanese imports. The Detroit-based companies would not suffer major damage from such an action, but the tariffs would severely harm the European and Asian based competitors that currently manufacture vehicles (and support jobs) in North America.

With the agreement, North America moves from free trade in automobiles and components within the zone to trade that is somewhat less free. It is closer to managed trade than pure free trade, but critically, it maintains the basic operating system of the automotive sector in North America and will not cause excessive disruption in supply chains.

The U.S. mid-term elections could have an impact on ratification of the USMCA. The Democrats, historically not the party that pushes free trade, have gained control of the House of Representatives.

And production cuts announced by General Motors that are likely to lead to the closing of assembly plants in Michigan and Ohio, have angered politicians from those states and could have repercussions if their constituents blame the new agreement for the closings.

Although leaders of all three countries have signed the agreement, it has not been passed by legislators in the United States, Mexico or Canada.

And, as recently as January 2019, President Trump has resurrected the threat of initiating the six-month process to terminate NAFTA. This move, he has said, will give legislators the choice of approving the new agreement or letting the North American trade regime revert back to pre-NAFTA days, when there was free trade between the United States and Canada, but not between Mexico and its partners in NAFTA and USMCA.