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PERSPECTIVE

NAFTA and the American auto industry

By Jonathan Michaels

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President Donald Trump shakes hands with Mark Fields, CEO of Ford, during a meeting with automobile industry leaders at the White House, Jan. 24.

During his campaign trail, President Donald Trump blasted the North American Free Trade Agreement (NAFTA), calling it "the single worst trade deal ever approved in this country," and promising to either renegotiate it or break it if he was elected. At the center of his attack was the U.S. automotive industry, which has been sending manufacturing jobs to Mexico since NAFTA's introduction in 1994 at a dizzying rate.

The goal of NAFTA was to eliminate trade tariffs between the U.S., Mexico and Canada, providing for a North American super-pack of sorts, and reducing the price of consumer products by enabling production at the most economically viable location. After 13 years of implementation, the U.S. Department of Commerce indicates that U.S. exports to Mexico have increased by 93 percent, and imports from Mexico have risen by 190 percent. The disparity of even trade has resulted in a U.S. trade deficit with Mexico of $49 billion, causing consternation among some policymakers and many economists.

Trump promises to reverse this trend by leaning on companies to bring jobs back to the U.S., or face a 20 percent important tariff if they do not. Ford recently capitulated to pressure put on it during the 2016 presidential race by scraping its plans to build a $1.6 billion plant in Mexico, opting instead, reluctantly, to construct a $700 million plant in Flat Rock, Mich.

On the surface, the move looks like a win for the American people, and perhaps it will be. But a much larger question looms of whether the U.S. would be better off by having the automotive industry leave Mexico in favor of the U.S.

If we lived in a binary world, where cars were either black or white, the question might be easy to resolve. But in an economy that is confronted with a kaleidoscope of issues, the answer is considerably more muddled.

To begin, Mexico has been a contributor to the automotive industry for about as long as cars have been in existence. GM has been building cars there since 1921, Ford since 1925, and today the country produces cars for GM, Fiat Chrysler, Ford, Nissan, Honda, Toyota, VW, Mazda and Kia, making it the eighth largest automobile producer in the world.

On the most basic level, bringing the automotive industry home would mean closing the factories in Mexico and building new ones in the U.S. The billions it would cost to replicate the plants in the U.S. would be good for builders in the local economies, but consumers would likely experience the brunt of the blow, as the manufacturers pass the costs on through higher retail prices.

And while the sound of bristling activity has a nice ring to it, the Detroit automakers, who shuttered thirteen U.S. plants during the recession, aren't exactly clamoring to open new ones. All indicators are that U.S. car sales are expected to slow, after peaking in 2016 at 17.6 million, putting the billions it would take to transplant the seven Mexican factories at risk. Idling factories rank high as one of automakers' greatest concerns.

If the factories were built, the labor force needed to run them would be substantial. GM, Ford and Chrysler currently employ some 36,000 workers in Mexico at an average cost of $8 per hour. The same labor force in the U.S., controlled by the United Auto Workers Union, demands a wage of $58 per hour, yielding an annual payroll for the three manufacturers of $4.3 billion — or about $3.6 billion more than the $600 million needed to employ the same workforce in Mexico.

While the rust-belt, and to some extent the nation, would be well-served with the influx of $4.3 billon in payroll dollars, it is no small guess where the year-after-year increased payroll obligation will land. And that's the good news.

If automakers buck the system — as Toyota is promising to do — and refuse to withdraw their Mexican operations, a 20 percent tariff on imported vehicles would be disastrous for consumers. Car buyers should expect to pay thousands more for the same product than they previously paid.

But the discussion of a 20 percent import tariff has a finer point, even for cars built in the U.S. Today, factories are more of assembly plants than true manufacturing facilities, where thousands of integral parts — many of which are sourced in Mexico — are homologated into a finished product. The Chevrolet Silverado, built in Fort Wayne, Indiana, has more than 51 percent of its parts made in Mexico, begging the question of whether it is a "made in America" car at all.

Further complicating the matter is the new world order, where the tens of thousands of parts that make up a vehicle often come from multiple producers in different countries, traveling travel back and forth across borders several times. As Steve Arthur, an automotive analyst at RBC Capital Markets stated, "The free flow of components is integral to the supply chain in auto manufacturing." It is not a situation that can be easily or inexpensively reversed.

With parts making up two-thirds of a car's value, a border tax on parts sourced in Mexico would still lead to increased consumer cost, even if the cars are assembled in U.S. factories. Jim Lentz, CEO of Toyota North America, stated that the cost of the Toyota Camry, which is made in Georgetown, Ky., would increase by about $1,000 with a 20 percent border tax.

If a border tax is instituted, there is also risk that automakers will leave Mexico, but not necessarily come to the U.S. Adam Smith, the father of modern day economics, would argue that automakers will run statistical comparisons, pitting high manufacturing costs of U.S. production against cheap labor, shipping expenses and import tariffs that would be realized by offshore assembly. With a cascade of opportunities in a globalized world, it is not certain that the U.S. would win that competition.

The Center for Automotive Research, a Michigan-based nonprofit, opines that "[a]ny move by the United States to withdraw from NAFTA or to otherwise restrict automotive vehicle parts and components trade within North America will result in higher costs to producers, lower returns for investors, fewer choices for consumers, and a less competitive U.S. automotive and supply industry." Whether that bears true remains to be seen, but one thing is all but certain: we are about to find out.

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