Canadian–U.S. auto pact—13 years after

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Canada and the United States agreed in 1965 to remove the duties on most automotive parts and equipment traded between the two countries. The agreement—known as the Automotive Products Agreement—recognized the similarity of the two markets in which practically the same automobiles are made and sold.

Although manufacturers in this country also make vehicles in Canada, until this agreement was reached, the two markets were separated by tariff restrictions. At the time of the agreement, in fact, the Canadian government was promoting development of the automotive industry in Canada by further trying to encourage production for export.

Objectives of the agreement were:

- To consolidate the two markets into a single automotive market, allowing increased benefits of specialization and large-scale production.
- To remove trade barriers, allowing industries in both countries to participate equitably in expansion of the market.
- To provide political and economic conditions that would allow market forces to determine patterns of investment, production, and trade in vehicles and parts on both sides of the border.

Though progress has been made, achievements in reaching these objectives still fall short of what both sides had hoped for 13 years ago.

Relations with Canada

Canada and the United States have long been close trading partners. About a fifth of the goods imported into the United States usually come from Canada, which, in turn, usually buys about a fifth of the goods exported from the United States. The two countries also rely heavily on each other as sources of investment. Nearly a fourth of U.S. direct foreign investment abroad is in Canada.

But for Canada, with an economy only about a tenth the size of the U.S. economy, these relationships are far more important than for the United States. Trade with the United States typically accounts for over two-thirds of Canada's foreign trade. And where Canadians own less than a fifth of the direct foreign investment in the United States, Americans account for four-fifths of the direct foreign investment in Canada.

The result has sometimes been friction between the two countries—Canadians feeling their economy is dominated too much by

Measured either in terms of employment or value added, the automotive industry is far more important in the Seventh District than in any other Federal Reserve district. The industry employs about an eighth of the manufacturing workers in these five states—Illinois, Indiana, Iowa, Michigan, and Wisconsin. Production of parts and vehicles accounts for roughly an eighth of the value added in manufacturing. In Michigan, it accounts for about a third of the jobs in manufacturing and a third of the manufacturing value added.

More than half the value added in the industry nationwide is accounted for at plants in the Seventh District. And close to three-fifths of the nation's automotive employment is in the district. More than two-fifths of the automotive jobs are in Michigan, and that state accounts for over a third of the nation's value added by the automotive industry.

Because of the importance of this industry in the Seventh District and the close ties between the industry in this country and the industry in Canada, automotive trade between the two countries remains a matter of continuing importance in the district.

the United States. Several times, to strengthen its position relative to the United States, Canada has adopted restrictive policies to protect its industries from trade with the United States. Just such a policy helped bring about the auto pact in 1965.

Canadian auto trade

Until the agreement was reached—up until 1968, in fact—the United States had a substantial surplus in its automotive trade with Canada. Canadian auto plants did not produce as many models as plants in the United States. And being operated mostly by subsidiaries of U.S. companies, they made models almost identical to those in the United States. Models that were not made in Canada were imported from the United States.

Canadian buyers, however, had to pay higher prices for roughly equivalent cars, whether the cars were produced here or there. Because of the smaller market in Canada, production runs were shorter there. Canadian plants had never reached the volume of output that had brought greater efficiencies and lower production costs at U.S. plants. To protect its industry from the more efficient U.S. industry, Canada taxed imported vehicles and parts. The tariff on assembled vehicles taken into Canada was 17.5 percent. Tariffs on some components ranged up to 25 percent.

Duties were imposed from both sides of the border. If anything, they were higher on this side. Tariffs on foreign cars brought into the United States ranged up to 25 percent. The tariffs, however, were aimed mainly at European and Japanese imports. Few Canadian-made vehicles came into this country. Almost identical cars were produced here at lower cost.

Duty remission program

To build up its own automotive industry, Canada initiated a duty remission program in the early 1960s. Some of the import duties on U.S. vehicles and parts sold in Canada would be returned to Canadian manufacturers that increased the Canadian value added in the vehicles and parts they exported. For every dollar increase in value added over a base period beginning in 1961, the manufacturer earned a dollar remission in import duties.

The program had the effect Canadians wanted. Investment in the Canadian auto industry increased. Although Canadian production also increased, there was no particular concern among auto makers in this country. They were also the big Canadian producers.

But some makers of parts in the United States felt the pinch. They charged that the program amounted to a subsidy on exports to the United States. Under the law of this country, the U.S. government had to respond to a Canadian export subsidy by imposing enough additional duty on vehicles and parts imported from Canada to offset the subsidy given Canadian producers.

Against this backdrop, the United States and Canada negotiated the automotive products trade agreement. The duty remission program was discontinued, and the stage was set for restructuring Canada's auto industry and unifying the industries in the two countries.

Restrictions in the agreement

Certain types of special purpose vehicles, such as fire engines, were excluded from the agreement, as were some types of equipment, such as tires. Generally, however, the two countries agreed not to impose duties on vehicles and the original equipment parts that went into their manufacture.

The main safeguard for U.S. companies has been a requirement that at least half of any vehicles or components imported from Canada be made either there or in the United States. This prevents a third country from shipping nearly completed cars into Canada, where with little more assembly work, the cars could be made ready for shipment to the United States as a final product, free of duty.

Safeguards for Canada are more restrictive. For a vehicle to be taken into Canada duty free, it has to be imported by a Canadian manufacturer of that type vehicle, the types covered by the agreement being cars, trucks, and buses. The manufacturer must have produced that type vehicle all four quarters of the 1964 model year and every year since. Three-fourths of the manufacturer's sales of that type vehicle, moreover, has to be made in Canada. And the proportion of the value added in Canada must at least equal the value added in 1964.

In addition, the Canadian government asked manufacturers in that country for assurances that they would work to increase the Canadian part of the production shared by the two countries. These assurances, made outside the provisions of the agreement itself, nevertheless, became integral to it. Covered by letters of understanding by Canadian subsidiaries of U.S. companies, they committed manufacturers to increase the Canadian value added in automobiles by 60 percent of any year-to-year increase in sales over the 1964 base. The requirement for trucks and buses was set at 50 percent. These separate agreements also committed manufacturers to increase the Canadian value added in auto production at least $260 million (in Canadian dollars or $241 million in U.S. dollars at the 1968 exchange rate) over the 1964 level.

The agreement is still in effect, as are the letters of understanding between manufacturers and the Canadian government. The agreement contains no termination date, though either government can withdraw from the agreement on a year's notice.

The agreement is not a "free trade" agreement. It comes closest to that in the United States, where, with some exceptions, vehicles and parts can come in from Canada duty free. In Canada, duty-free entry still depends on conditions that promote development of the Canadian auto industry, as for example, entry of vehicles and parts only through Canadian manufacturers.

Effects of the agreement . . .

One of the first effects of the agreement was to bring the industry into a concerted effort to unify production in the two countries. As a result, there was considerable restructuring of the industry, especially in Canada, where auto makers began concentrating production of certain parts and particular models. Although fewer models were made in Canada, more vehicles were produced there overall. Models that were not made there could easily be brought in from the United States.

Much the same changes were going on in the United States, the difference being that because the industry was much bigger in this country, the changes were not as important here.

The upshot was that where equivalent models built in the two countries had been similar but not quite the same, they soon became almost identical. In recent years, in fact, Canada has been the sole source for some models.

. . . on production . . .

The agreement had been keyed, of course, to promotion of the industry in Canada. But auto production there was already on the rise. As in the United States, demand for vehicles was expanding. Spurred by the duty remission program, there had

Automotive production expands faster in Canada

Period	United States Cars	United States Trucks and buses	Canada Cars	Canada Trucks and buses
	(thousands of units)			
1960-64 average	6,907	1,322	434	84
1965-69 average	8,485	1,806	803	232
1970-74 average	8,182	2,407	1,087	302
1975	6,740	2,251	1,057	390
1976	8,538	2,946	1,143	501
1977	9,294	3,424	1,167	603

SOURCE: *Annual Report of the President to the Congress on the Operation of the Automotive Products Trade Act*, January 1976, and March 1977. *Automotive News*, selected issues.

already been a surge in investment in Canada's automotives.

Canada's share of the combined production in the two countries increased from 4.6 percent in 1960 to 6.7 percent in 1964. By 1970, its share had climbed to 11 percent. In 1974 and 1975, when higher oil prices sparked demand for more gas-efficient cars, Canadian plants, being more geared for small cars than U.S. plants, saw their share of production jump to 13.6 percent. Since then, the Canadian share has eased back, probably to around 12 percent.

The Canadian share of truck production has continued a fairly steady uptrend, rising from 5.5 percent in 1960 to 6.5 percent in 1965 to 15 percent in 1977.

. . . trade . . .

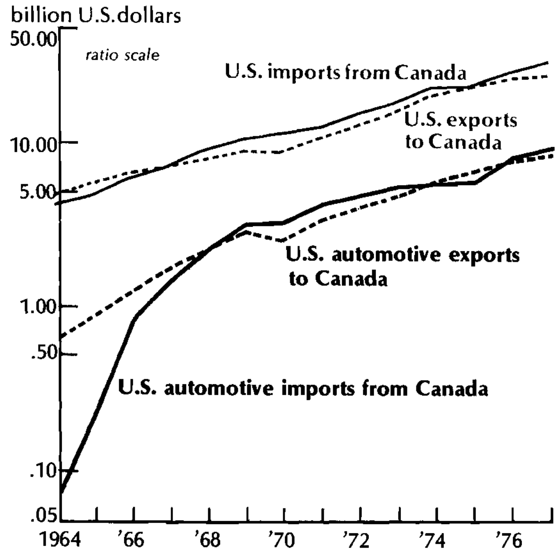
The Canadian auto market expanded rapidly in the early 1960s. Unit sales increased 64 percent from 1960 through 1964. But automotive production increased even faster, expanding 69 percent. Growth in sales in Canada slowed considerably after that, increasing only 19 percent from 1964 to 1968. But production continued even faster, expanding 75 percent. Where Canadian production was slightly less than domestic sales in 1960, it exceeded sales by 23,000 units in 1964, 400,000 units in 1968, and 660,000 units in 1971.

Most of this extra production was exported to the United States, where sales began pulling ahead of production early in the 1970s. Reflected in the change was the shift in plant facilities as Canadian subsidiaries of U.S. companies expanded their value added in production to increase their share of the total.

As a result of the agreement, automotive trade between the two countries has increased dramatically. Last year, U.S. exports of automotive products to Canada reached $8.4 billion—a tenfold increase since 1965. But U.S. imports from Canada reached $9.1 billion—a fortyfold increase.

Until 1968, the United States had a trade surplus with Canada in vehicles and parts.

Canadian-U.S. automotive trade surges



SOURCE: U.S. Department of Commerce and the Ninth Annual Report of the President to the Congress on the Operation of the Automotive products Trade Act of 1965.

Since then, except for 1974 and 1975, when the recession brought a sharp drop in demand for vehicles in the United States, the surplus has been in Canada's favor.

Canada's surplus is based on the much larger export of assembled vehicles. The United States still has a surplus in automotive parts, the size of which accounts largely for its trade surplus with Canada in 1974 and 1975.

The Arab oil embargo in 1973 and 1974, the fourfold increase in prices of imported oil, and the decline in business activity in the United States in 1974 and early 1975 slowed auto purchases here much more than in Canada. Canadian purchases of vehicles in 1974 and 1975, in fact, were well above earlier levels, as were imports of parts and assembled vehicles from the United States.

Sales in the United States, on the other hand, were off sharply, unit sales averaging 16 percent less in 1974 and 1975 than in 1972 and 1973. Imports increased only marginally during the recession, and even that increase was due mainly to Canadian plants being oriented more to the production of small cars.

Dependence of Canadian plants on

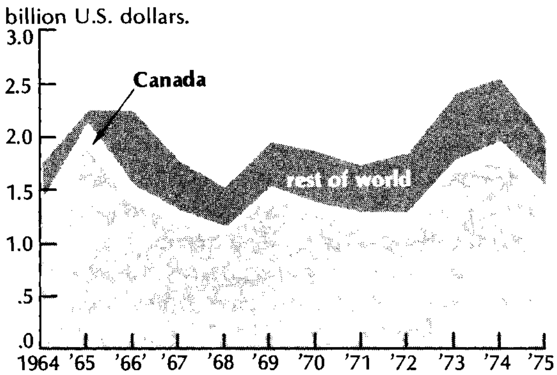
manufacturers in the United States for parts, in fact, has prompted independent manufacturers of parts in Canada to seek additional protection from parts imported from the United States.

. . . investment . . .

The automotive trade agreement did not, in itself, seem to have brought any great surge in investment in Canada's industry. There was a substantial increase in spending on automotive plant and equipment in the early 1960s. But that was due mostly to investments made to take advantage of the duty remission program. There was substantial investment later in the 1960s and early 1970s by independent manufacturers of parts and commercial vehicles. But Canada experienced no increase in the proportion of total investment in the two countries by the four largest auto makers.

Net new investment of these four companies in Canada totaled $125 million in 1964. That was 8.7 percent of the investment in automotives in the two countries that year. The Canadian share peaked the next year at $194 million. That was 9 percent of the 1965 total. Most of this spending in the year of the agreement had already been committed,

Capital expenditures on plant and equipment in Canada continue modest relative to the U.S.*



*Estimated capital expenditures on plant and equipment by General Motors, Ford, Chrysler, and AMC in the U.S., Canada, and the rest of the world.

SOURCE: Automotive Task Force, Review of the North American Automotive Industry, Canadian Department of Industry, Trade and Commerce, April 1977.

however. Ten years later, Canadian plants accounted for only 6 percent of the net new investment these companies made in the two countries.

. . . and employment and labor costs

Employment in the automotive industry has fluctuated widely in both countries since the agreement went into effect. Some of the swings have, of course, come with shifts in demand for vehicles. Generally, however, workers have fared better in Canada than in the United States, the movement in employment there tending more consistently upward.

In 1975, for example, when the recession put a squeeze on auto sales, employment in automotives in the United States dropped to a level 8 percent lower than in 1965. In Canada, the number employed in the auto industry was 22 percent higher than when the agreement went into effect. Annual employment in the auto industry in the United States for 1970-74 averaged 1 percent higher than for 1965-69. In Canada, the average was 16 percent higher.

Though most of the difference is due to Canada's increased share of auto production, some of it may be due to the lower productivity in Canadian plants. Measured as value added per manhour, productivity is higher in both countries than when the agreement was made. But according to estimates by the U.S. International Trade Commission, the number of manhours needed to assemble a vehicle in Canada can be up to 6 percent more than in the United States.

This difference, in turn, helps account for the higher unit cost of vehicles assembled in Canada. Furthermore, Canadian assembly line workers draw pay on a par with their counterparts in this country. As a result, the difference in productivity adds further to the higher unit cost of vehicles assembled in Canada. But because of a different occupational mix in the automotive industries in the two countries, the average wage of auto workers in Canada still remains lower than in the United States, though the difference is narrowing.

Employment in automotive products manufacturing increases

Period	United States	Canada
	(annual average in thousands)	
1964	752.9	69.3
1965-69	861.0	84.6
1970-74	869.8	97.8
1975	774.1	98.9
1976	850.6	n.a.
1977	890.6	n.a.

SOURCE: *Tenth Annual Report of the President to the Congress on the Operation of the Automotive Products Trade Act of 1965.* The U.S. Department of Labor. *Statistics Canada.*

With overall production costs higher in Canada, prices of comparable cars are also higher there—though, here too, the difference is narrowing. The difference would have narrowed faster if buyers could have imported duty-free cars from the United States without having to go through Canadian manufacturers. In 1965, the suggested retail price of a typical medium-sized car ranged up to about a third higher in Canada than in the United States. In 1976, the difference was still about a sixth higher.

Automotive price differentials narrow for some models[1]

Year	United States	Canada	Canadian price differential over U.S. price
	(U.S. dollars)[2]		*(percent)*
1965	4,486	5,825	29.8
1974	6,542	7,853	20.0
1975	7,701	9,313	20.9
1976	7,898	9,201	16.5

[1]Manufacturer's suggested retail price of the same car in the United States and Canada. Prices quoted are for a two-door sedan with an eight-cylinder engine and comparable standard equipment. Price differentials vary according to make and model.

[2]Canadian prices are converted to U.S. dollars for December of the model year introduced. In U.S. cents per Canadian dollar, the rates are: 1965, 92.5; 1973, 100.06; 1974, 102.25; 1975, 98.63.

SOURCE: *Tenth Annual Report of the President to the Congress on the Operation of the Automotive Products Trade Act of 1965.*

Though employment in the auto industry overall has increased during the past 13 years, disruptive effects of the agreement show up in the adjustment assistance given to workers that lost their jobs to workers in the other country. The agreement committed both governments to assist affected workers, whether unemployed or threatened with the need to relocate. Under this commitment, which ran through 1968, assistance was given to 2,500 workers in the United States (63 percent of them in Michigan and Wisconsin) and 3,100 in Canada.

Assistance to U.S. workers continued after 1968. Following the surge in oil prices in 1974 and the increase in demand for small cars, most of which were imported, 110,000 workers filed applications for adjustment assistance. About half of the applications were filed on grounds that jobs had been lost to imports from Canada, the other half claimed losses due to imports from Europe and Japan. About half of all the applications were approved by the U.S. Labor Department.

Conclusion

After 13 years, the original hope that the automotive products agreement would lead eventually to a free-trade arrangement between the two countries has clearly not been fulfilled. There has been some success, the biggest accomplishment being the unification of the auto industry. Production in Canada has been reorganized. Plants there are more efficient than 13 years ago, and the difference in auto prices has narrowed. The agreement, however, still insulates the Canadian auto industry from the more efficient U.S. industry.

If the agreement were to be renegotiated, as has been proposed on both sides of the border, there would be pressure for the Canadians to give up some of their safeguards. While the safeguards would probably, at best, be given up only over a long period and would most likely take further restructuring of the Canadian industry, the change would be toward a more efficient automotive industry for the Canadians.