North American Trade and the Auto Sector: Welcome and Opening Remarks

Charles L. Evans
President and Chief Executive Officer
Federal Reserve Bank of Chicago

Forging a New Path for North American Trade: The Auto Sector
Detroit, MI
September 4, 2019

FEDERAL RESERVE BANK OF CHICAGO

North American Trade and the Auto Sector: Welcome and Opening Remarks

Charles L. Evans
President and Chief Executive Officer
Federal Reserve Bank of Chicago

Introduction

Good afternoon. I'm Charlie Evans, president and CEO of the Chicago Fed. It's my pleasure to welcome you to the Chicago Fed's only branch. Our Detroit Branch was established in the Motor City 92 years ago. As you can tell, we are not in the original building. That is located downtown on Fort Street and still standing. I hear it is now home to a popular restaurant.

We are here today to discuss how North American trade affects the auto sector. It is fitting that this conference is held here as Detroit occupies a unique role in the history of this industry. For example, we're about a five-minute drive away from the Ford Piquette Avenue Plant. Built in 1904, that plant was the original Model T factory. Detroit also occupies a special place in North American trade relations. Along our lengthy border with Canada it represents one of the key border crossings. Connecting Detroit and Windsor, Ontario, the Ambassador Bridge alone facilitates about a quarter of all trade between the U.S. and Canada.[1] By the way, in this building we're close enough to the border that on a clear day you can see Canada from here. All you have to do is look south.

---

[1] Data from the U.S. Department of Transportation, Federal Highway Administration, "Ambassador Bridge crossing summary," available online, https://ops.fhwa.dot.gov/freight/freight_analysis/ambass_brdg/ambass_brdge_ovrvw.htm.

Macroeconomy and trade

It's worth reminding ourselves of the role that trade plays in the overall economy and how economists think about it. Going back to Ricardo and Samuelson,[2] macroeconomic analysis teaches us that the value of international trade lies in its ability to expand economic opportunities. We often talk about the benefits of trade. What do we mean by that? International trade allows countries to more fully exploit their comparative advantages. Trade fosters cross-border competition among businesses, which in turn leads to productivity enhancement and innovation. Conversely, insulation from international market forces typically reduces a business enterprise's motivation to innovate, as it faces less competition.

At the Chicago Fed, we estimate that the U.S. economy's trend growth potential currently stands at around 1-3/4 percent. Many have hoped this trend could be 3 percent or higher, but the realities of labor markets and business strategies are limiting the economy's long-run growth potential. Our low trend growth estimate is based on demographic and productivity arithmetic: Roughly speaking, we expect labor hours to grow by one-half percent and labor productivity to grow by 1-1/4 percent on an annual basis. But if we were to see a reduced competitive environment with less productive innovation, productivity growth would be even lower. And if there were an increase in restrictions on legal immigration and related actions on undocumented

[2] David Ricardo (1772–1823) was a British economist, and Paul Samuelson (1915–2009) was an American economist. Both made major contributions in developing tools to illustrate the benefits of trade.

immigration, then the growth in trend labor hours would be weaker as well.[3] Putting all this together, trend growth in the U.S. could end up being closer to 1-1/2 percent or even lower. (And that doesn't address how this trend growth would be shared by different income and skill groups.)

In addition, there's increased uncertainty among the business community as a result of the new trade policy. When businesses are weighing whether or not to make substantial investments, uncertainty tends to slow down such decisions.[4] The auto industry has been especially challenged by the uncertainty posed by actual and proposed changes in trade policy, as its production operations in the United States, Canada, and Mexico are closely linked across the three countries.

With so much at stake for America, these are crucial issues for all of us to be aware of.

Specific impacts on the auto industry

The North American auto industry wasn't always as integrated as it is today. Back in 1965 the U.S. and Canada reached an industry-specific agreement that eliminated all tariffs on vehicles and parts passing between the two countries. This Auto Pact of 1965 was followed in 1989 by the Canada–United States Free Trade Agreement (CUSFTA), which further liberalized trade between the two nations. Mexico began to liberalize its trade policy during the 1980s. That process culminated with Mexico entering into the North American Free Trade Agreement (NAFTA) with the U.S. and Canada. This

[3] According to a policy brief from the Committee for Economic Development of the Conference Board, "the population of native-born 18- to 64-year-old workers in the US will expand by just 0.1 percent on average from 2017 to 2027. Immigrants will therefore be the primary source of labor force growth" (Schaitkin, 2018, p. 4).
[4] See, for example, Handley and Limão (2017) and Carballo, Handley, and Limão (2018).

region-wide trade pact came into effect in 1994 and removed most of the remaining trade barriers between the three nations.

Tomorrow morning's keynote speech will address the lessons we have learned from NAFTA—the regional trade agreement that has been in place for more than 25 years. During that time, producers of vehicles and parts have integrated their operations across North America. Last year 16.9 million light vehicles were produced in North America. And most of them were sold within the region. The integration of economic activity in the auto sector also extends to the industry's supply chain. Parts and subassemblies typically cross international borders multiple times before they reach the vehicle assembly line. According to recent work by Alonso de Gortari, 38 percent of the value added in cars produced in Mexico (and sold in the U.S.) originates from the U.S.[5]

Today 14 companies produce vehicles in North America—nearly all of them are headquartered overseas. Five of these companies started producing vehicles in the U.S. after NAFTA came into effect. Over half of them operate production plants in more than one NAFTA country, taking advantage of the fact that North America is one integrated economic region. It is fair to say that today North America is among the world's most competitive regions for vehicle production.

---

[5] De Gortari (2017).

Concluding thoughts

Importantly, the context and tenor of trade policy discussions have been changing of late. While much of the attention has been focused on our trading relationship with China, there have also been major developments in trade relationships with other nations, including Mexico and Canada. For example, a new free trade agreement was negotiated for North America last year. It currently awaits ratification by the U.S. and Canada. Mexico ratified it in June. What are some of the implications of this new agreement? According to the United States International Trade Commission, the agreement's tighter rules of origin for auto parts and vehicles are likely to have a significant impact. But overall, the commission anticipates the agreement will have a moderately positive effect on the U.S. economy.[6]

While competition and innovation enhance the overall welfare of trading partners, the changes they engender can create both winners and losers. This presents a challenge for economic policy. For example, while we are meeting here, negotiations for new labor contracts between the Detroit Three automakers and the UAW (United Automobile Workers) are under way. I would think that trade and its effects feature prominently in those negotiations.

During the conference we will discuss how public policy can mitigate the adverse effects of trade while enhancing its benefits. The role of labor will certainly be a focus in those discussions. We'll also get regional perspectives—for instance, we'll hear from

[6] United States International Trade Commission (2019).

Congresswoman Debbie Dingell from the 12th District of Michigan and from our friends and partners in Canada.

Finally, I would like to mention that the Dallas Fed will be hosting a complementary conference on North American trade in three weeks. That event will look more closely at U.S.–Mexico relations and address trade and immigration issues from a broad perspective.

To close, let me say that I am delighted so many of you are here today. I look forward to the stimulating discussions we'll have during this conference.

Thank you.

References

Carballo, Jerónimo, Kyle Handley, and Nuno Limão, 2018, "Trade cold wars and the value of agreements during crises," VoxEU.org, March 16, available online, https://voxeu.org/article/trade-cold-wars-and-value-agreements-during-crises.

De Gortari, Alonso, 2017, "Disentangling global value chains," Harvard University, job market paper, October 20, available online, https://www.semanticscholar.org/paper/Disentangling-Global-Value-Chains-%E2%88%97-JOB-MARKET-Gortari/8821b60a1d6c6f9a15e3e22f48649c5415bda985.

Handley, Kyle, and Nuno Limão, 2017, "Policy uncertainty, trade, and welfare: Theory and evidence for China and the United Sates," *American Economic Review*, Vol. 107, No. 9, September, pp. 2731–2783, available online, https://www.aeaweb.org/articles?id=10.1257/aer.20141419.

Schaitkin, Brian, 2018, "The power of more foreign-born workers: How raising immigration levels can boost US economic growth," Committee for Economic Development of the Conference Board, policy brief, January, available online, https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=7678.

United States International Trade Commission, 2019, *U.S.-Mexico-Canada Trade Agreement: Likely Impact on the U.S. Economy and Specific Industry Sectors*, report, Publication No. 4889 (Investigation No. TPA 105-003), Washington, DC, April, available online, https://www.usitc.gov/publications/332/pub4889.pdf.