

## Intelligence Memo Flashback

US NAFTA negotiators have amended their position on content rules for the auto industry. This is a major breakthrough in the negotiations because the issue was one of the 'poison pills' that Canadian and Mexican officials identified as a serious obstacle in the talks. Last fall Christopher Sands cogently outlined the complexities of North America's Autoplex in two Intelligence Memos. We reprint the first of those today.

Date: March 21, 2018

Re: **PLAYING CHICKEN WITH CANADA, MEXICO AND THE NORTH AMERICAN AUTO INDUSTRY (PART ONE)**

The United States used round four of the NAFTA renegotiation talks to launch its proposal for adjustments to the North American automotive industry. The text of the U.S. proposal hasn't been made public, but some details have been circulating in Washington.

The U.S. is calling for an 85 percent rule of origin for tariff-free treatment (up from 62.5 percent) with a 50 percent "domestic content requirement" meaning that half the content must originate in the economy where the final product is sold.

In addition, the United States proposed to end tariff-shifting, a new name for the longstanding practice of changing the treatment of a product through [substantial transformation](#) that results in a change in the tariff classification of an item. U.S. Secretary of Commerce Wilbur Ross wrote [an article](#) in the *Washington Post* on September 21 in which he sharply criticized substantial transformation as a flaw in the NAFTA rule of origin.

As well, the United States called for full traceability on origin to certain [raw materials](#), a more rigorous enforcement of the rule of origin and one that would add to compliance costs for firms.

Each element of this proposal has important implications for the structure and profitability of automotive manufacturing in North America.

Raising the rule of origin to 85 percent would require sourcing more components locally, which is possible in principle for the firms. Yet some components, such as [semiconductors](#), are not available from wholly North American sources and contain elements from several countries. Similarly, some suppliers rely on Germany for specialty steel that is not made here. Add the 50 percent requirement for domestic content, and automakers must carefully calculate ways to find new sources for thousands of components to meet these new rules.

This makes the transition or phase-in period for a new NAFTA 2.0 requirement critical. In the North American auto industry, the planning for a new vehicle is a seven to 10 year process. Adjustments over this time frame can be planned for, but with the proposed deadlines the auto firms are stuck with existing contracts with suppliers and investments in plants and equipment.

The elimination of tariff-shifting would deny the firms an important coping mechanism. The substantial transformation rule has been a part of U.S. trade policy since the General Agreement on Tariffs and Trade came into effect in 1948. If a firm takes German steel and bends and reforms it into, for example, a piston, that piston can be counted as locally-sourced. This benefits the United States because there is more money to be made in sophisticated piston manufacture than in basic steel production. Tariff shifting allows North America to retain higher-paying, higher-technology jobs and benefit from raw materials at the best price globally.

For many commodities like resin feedstocks and minerals, the global market is not designed to provide consistent origin but to offer low prices.

This is where the US proposal for origin traceability becomes significant. The major assemblers rely on a hierarchy of suppliers for important vehicle subsystems. Suppliers are dubbed Tier One if they sell directly to the final assembler – the company whose brand is on the vehicle. Tier Two firms sell to Tier One firms, Tier Three sells to Tier Two and so on. Under NAFTA each purchaser asks the supplier to certify the origin of what is sold. At the lowest tier in the supply chain, where a supplier will be most likely to use raw materials, those sources fluctuate as companies seek the lowest commodity prices.

Final assemblers have traditionally encouraged this, both to keep costs down and also because the value-added finished product is seen as more important than the raw material. Full traceability eliminates the opportunity to do this by making content count at every step in the value chain.

In [Part Two](#) we discuss further implications and where this all may be headed.

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