Intelligence MEMOS

From: Stephen Beatty and Daniel Schwanen

To: Trade War Observers

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Re: **Auto Trade with the United States: Back to the Future?**

Yesterday, Donald Trump announced a 25-percent tariff on all passenger vehicles and light trucks, as well as key automobile parts imported from all countries.

Given the integration of the Canadian and US auto industries, this announcement is potentially the most portentous blow Mr. Trump has landed on Canada since his inauguration on January 20. Without the free trade first-best option, we must focus our attention on finding a second-best.

The White House is imposing this tariff under the same Section 232 of the *Trade Expansion Act* of 1962, which it also used to put tariffs on imports of steel and aluminum – these are meant to protect industries whose decline is deemed a threat to US national security.

For those who import vehicles made in Canada or Mexico under the CUSMA/USMCA, the only silver lining is that the tariff will apply to the value of the vehicle net of their US content, which is typically substantial. Parts from Canada and Mexico imported into the United States will also get a temporary reprieve from the tariff, until the US officials can figure out how to net out their US content to calculate the value on which it will apply the tariff.

Canada needs to find a way to parry Trump's move. The threat to our manufacturing base is real.

Consider the options. Between the probably now unattainable first-best option of open North American trade under CUSMA (for goods meeting North American rules of origin), and the two costly ideas of either exiting the car-making business altogether or building all the cars sold here at home – right now only 9 percent of cars sold here are assembled in Canada – there is a genuine second-best option. That option would allow us to remain inside the new US tariff wall.

It harks back to something which Canada implemented successfully in a distant past, but which has become relevant again today, given the situation.

Prior to the 1965 Canada-U.S. Auto Pact, tariffs applied on most trade, including Canadian automotive imports. Essentially, cars for sale duty-free in Canada were limited to those made here, which meant that the Canadian industry was hooked on multiple but small, inefficient production runs. To offer Canadians more competitive choices while still maintaining a domestic industry, Canada created a system of duty remissions, by which tariffs were waived for imports from those auto producers that also maintained a certain minimum production in Canada.

The Auto Pact arrived on the scene due to the reaction of US auto parts manufacturers to this system. It contained reciprocal tariff-free access provisions on both sides of the border, still linked to minimum assembly levels in Canada, but allowing the North American industry to rationalize production across both countries and keep choice plentiful and prices low.

We now need to contemplate a system like that old one. Canada should raise its light-vehicle tariffs against all countries with which it does not have a free trade agreement (or one effectively guaranteeing mostly tariff-free trade). The hike would be to a similar level that the United States is imposing against all countries. There would be a surtax on the import value of US light vehicles, excluding their Canadian content from the tax. At the same time, auto manufacturers currently assembling vehicles or manufacturing major powertrain components in Canada should be provided with duty remission on imported parts and components proportionate to their Canadian production. These steps would favour a floor for Canadian production.

This initiative would upset the applecart and be aimed at driving negotiators back to the CUSMA table to review its automotive provisions, which the United States clearly thinks, with some justification, are ineffectual at keeping auto production from leaking to Mexico and third-party countries. Canada's share of North American production has been declining, and it is not a threat to the United States.

This proposed approach would also offer benefits to the United States, not least by drawing on existing Canadian skills and investments in the sector, which support its own industry's competitiveness. Manufacturers would continue to be able to rely on suppliers across the region including a growing critical mineral and battery supply chain base in Canada. Unlike tariff preferences, the program would not require a large government administrative role. And because it offers by far the largest market, the US would continue to be the first location that any company seeking to expand into North America would invest, leaving the U.S. with a sustained competitive advantage, albeit in the context of balanced trade (as is the case now) with Canada.

Canada can't throw in the towel, and the self-sufficiency game has highly uncertain outcomes. We need to offer a deal to the United States that it will find attractive. A new Canadian tariff coupled with a duty-remission scheme is how we get it to the table.

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