Autos: A Tariff Too Far

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For much of the past 18 months, the conventional wisdom on the trade front has been that President Trump's protectionist bark is worse than his bite; that trade threats are bluster and/or a negotiating tactic; and that cooler heads will prevail. Wrong, wrong, and wrong. Instead, we have a very real trade tussle between the U.S. and China, tariffs on Canadian steel, aluminum, lumber, and newsprint, and NAFTA negotiations which face U.S. demands that are simply unacceptable to Canada and Mexico. Accordingly, there is the dawning realization among investors and analysts to not dismiss any trade threat, and that includes the possibility of a 25% tariff on imported autos. While we doubt that the U.S. would go as far as to impose a permanent, broad-based tariff on auto imports of that magnitude—partly because of the damage it would do to the U.S. economy, and the pain it would inflict on middle class American consumers (*see last week's Focus*)—we simply can't rule out the possibility. With that background, we delve deeper into the Canadian auto sector, and how it could potentially be affected by U.S. tariffs.

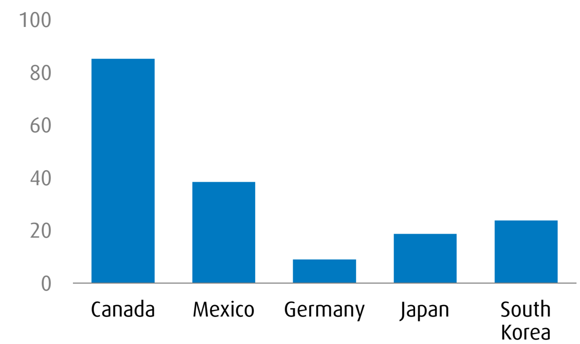
The Canadian automotive industry possesses many unique characteristics that only exist in the context of the tight political and economic partnership between Canada and the U.S. It is a prime example of the application of comparative advantage. Beginning with the Auto Pact of 1965, operations have been refined over 50 years through supply chain optimization and strong supplier relationships. Canada's annual auto manufacturing capacity stands at just above 2 million units, with the U.S. closer to 12 million units and Mexico approaching 4 million. Auto and parts manufacturing directly account for 1% of Canadian GDP, down from pre-financial crisis levels of 1.5%, following the closure of several facilities. Direct employment in auto and parts manufacturing currently stands at over 130,000 workers (0.8% of total payrolls), down from a peak of 170,000 in the early 2000s, but up 10% over the past three years.

Of the 2 million vehicles manufactured in Canada, 85% are exported to the United States, up from 65% in the early 1990s. For context, the country with the next largest U.S.-export intensity is Mexico, whose ratio stands at just 38% (*Chart 1*). Such dependency can only be formed after decades of trust, which appears to be fraying. This is particularly concerning given the trade relationship extends both ways, with Canada the destination for roughly 40% of total U.S. autos and parts exports. Two-way auto and parts trade accounts for over US$110 billion, with Canada acting as a net exporter of finished vehicles and a net importer of parts. Combined, **the well-oiled relationship resulted in a modest $2.5 billion net autos surplus for the U.S. in 2017, which is remarkably balanced** given more than $500 billion of overall trade flows between the two countries (*Chart 2*). Tariffs in the range proposed by the Department

Chart 1
High Reliance on U.S. Trade

2016 (% of auto production exported to the U.S.)

Auto Export Intensity to the United States

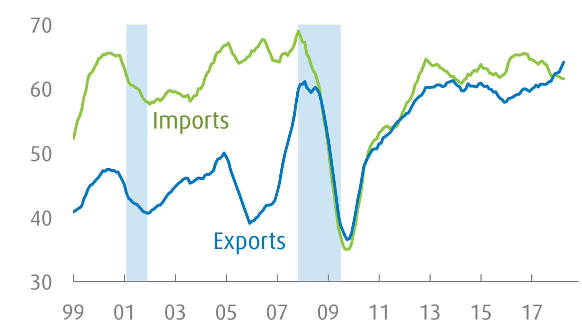


Source: BMO Economics

Chart 2
Auto Trade is Balanced

United States (US$ blns : 12-mnth m.s.)

Vehicle and Parts Trade with Canada



Shading marks periods of U.S. recession
Sources: BMO Economics, Haver Analytics

of Commerce risk fracturing this relationship and, more seriously, risk damaging the effectiveness and competitiveness of the North American production chain in the face of steadily growing international competition.

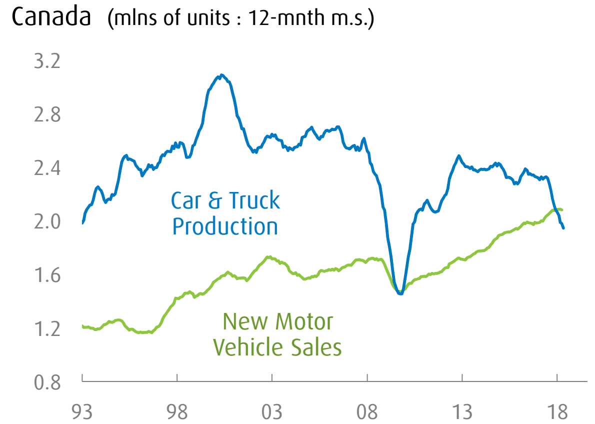
Focusing on finished cars and trucks, 44% of all vehicles purchased in the U.S. are imported, meaning nearly half of the market could be subjected to tariffs of up to 25%. **The ability of U.S. production to capitalize on the price distortions caused by the tariffs in the near term is extremely limited given plants are operating at 97% capacity**. Even if all U.S. auto exports were redirected to the domestic market, worsening the trade deficit, it would only add 2.8 million units of supply (16% of domestic demand), and this ignores that the vehicles in question would be imperfect substitutes (implying a loss of consumer welfare).

Industry commentary suggests that a tariff of 25% would be met with a 15%-to-20% increase in the wholesale price of a vehicle. Making a generous assumption on the price elasticity of demand, **we assume a 10% decline in U.S. sales from our baseline forecast**, to just over 15 million units. Despite punitive tariffs, nearly 5 million imported vehicles would still be required to satisfy domestic demand even if U.S. plants ramped up to full capacity. In the extreme case where the U.S. ceased all exports, 3 million import units would still be needed. These outcomes would entail a 35%-to-60% drop in import volumes from current levels of around 7.5 million units, which would hit Canadian production disproportionately hard. Of course, the consequences would be magnified if the tariffs are extended to parts.

The **impact on Canada's economy would be significant**, and possibly large enough to pull Ontario specifically down to near recession territory. Given the above range of U.S. import volume changes resulting from the tariff, Canadian auto production could be cut by somewhere in the 600k-to-1 million unit range. Assuming a similar impact through the parts supply chain, **this would directly carve roughly 0.3-to-0.6 ppts from Canadian GDP, and could put at least 40k factory jobs at risk**. Of course, the impact wouldn't stop at the factory gate. Income losses would flow through to lower consumer spending; sectors that derive business from autos, such as transportation & warehousing, would see activity decline; the impact would likely disrupt the wholesale and retail networks, which employ twice as many people as parts and production; and the broader hit to business confidence would certainly dent capital spending in other sectors. Tempering the decline somewhat would be a weaker Canadian dollar, a potential response from the Bank of Canada and any government support measures (for which there is precedent). While measuring the impact of such spillover effects is far from precise, our analysis suggests that **the broader impact on GDP could run in the 0.6-to-1.2 ppt range** after a year.

In Ontario, the consequences would be more severe given that the province accounts for nearly all of Canada's auto and parts production, and U.S.-bound autos and parts account for 30% of the province's total exports. In fact, we estimate that the direct impact of lower production could alone cut almost a percentage point from growth, leaving the broader impact closer to 2 ppts. In a nutshell, the hit to production and auto-sector employment would not be far behind that experienced during the financial crisis in 2009. While the broader impact would be tempered by still-solid economic fundamentals in other sectors, **Ontario could very well see a modest recession** versus our baseline forecast of around 2% growth in 2019. Another key concern is that, given the highly localized nature of the auto sector, specific **communities in Southwestern Ontario could see an impact far beyond that for Ontario or Canada overall**, and an acceleration of the hollowing out process that has been underway for more than decade (*Table 1*). Moreover, the economic impacts could be more severe than suggested given the attendant risks of plants operating at low capacity and unprofitable levels.

Chart 3
Production and Domestic Demand



Sources: BMO Economics, Haver Analytics

Canada does have one notable advantage: Domestic capacity of over 2 million units can still meet domestic demand (*Chart 3*). Should Canada apply a 25% countervailing tariff on U.S. imports (and potentially other imports to protect domestic assemblies), it **could see demand shift to Canadian-produced vehicles and maintain production at higher levels than otherwise would be the case**. Unfortunately, for this strategy to have maximum impact, duties would also need to be levied to all trading partners to prevent a re-routing of once-U.S. bound vehicles into the Canadian market to fill the void left by U.S imports. This would have separate ramifications, including a breach of Canada's CETA commitments, break in solidarity with Mexico with regards to NAFTA negotiations, not to mention a limited selection of available vehicles for consumers and higher prices biting purchasing power.

Bottom Line: The auto industry remains one of the most important sectors in the Canadian economy—acutely so for Ontario—even with its relative downsizing over the past two decades. Potential U.S. tariffs would land a heavy blow on the economy, but would also inflict serious pain on U.S. consumers and workers. Given that the U.S. industry doesn't have the capacity to meet domestic demand for the foreseeable future, any tariffs are likely to be either temporary, and/or less than 25%, or ultimately exempt Canada. Still, even the threat of tariffs can chill capital spending decisions, and cannot be lightly dismissed as a key risk.

Table 1
Vehicle Production in Canada

	Vehicle Production —12 months through May— (units)		Volume (% chng)	Share of Company's NAFTA Production (percent)		
Company	2018	2017		Current	Year-ago	Models Produced
FCA	**497,850**	**529,112**	**-5.9**	**21.3**	**22.9**	
Brampton	216,904	220,949	-1.8	8.3	9.4	300, Challenger, Charger
Windsor	280,946	308,163	-8.8	13.0	13.6	Caravan, Pacifica
Ford	**233,236**	**265,604**	**-12.2**	**8.5**	**8.1**	
Oakville	233,236	265,604	-12.2	8.5	8.1	Edge, Flex, MKT, MKX
GM	**289,627**	**506,609**	**-42.8**	**9.4**	**13.9**	
Ingersoll	205,691	399,799	-48.6	6.8	7.7	Equinox
Oshawa 1	65,039	65,850	-1.2	1.8	2.8	Impala
Oshawa 2	18,897	40,960	-53.9	0.8	3.3	Regal, XTS
Honda	**392,828**	**417,137**	**-5.8**	**22.4**	**23.8**	
Alliston 1	192,791	205,085	-6.0	10.9	11.4	Civic
Alliston 2	200,037	212,052	-5.7	11.5	12.4	CR-V
Toyota	**488,666**	**604,575**	**-19.2**	**26.6**	**30.0**	
Cambridge	269,538	352,540	-23.5	14.7	17.5	Corolla, RX350
Woodstock	219,128	252,035	-13.1	11.9	12.5	RAV-4
Total	**1,902,207**	**2,323,037**	**-18.1**	—	—	

Source: BMO Economics