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GLOBAL ECONOMICS

INSIGHTS & VIEWS

December 10, 2024

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Freeways and Free Trade: North American Automotive Markets Expect Shocks To Come

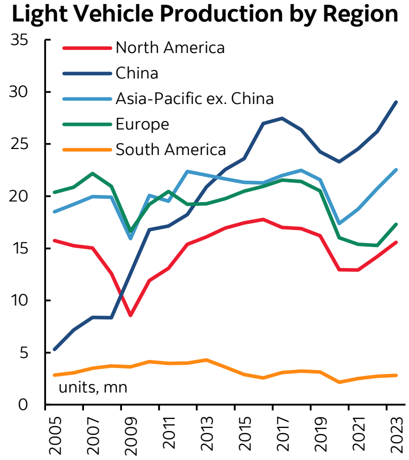
TARIFFS, REGULATORY REPEALS, USMCA REVIEWS AND CHANGES TO THE IRA ARE ALL RISKS THAT LOOM LARGE FOR THE CONTINENT'S AUTO MARKETS

- **North America's automotive sector has seen years of recovery and rebalancing from supply and demand-related shocks. While many of these effects have abated, new policy-related risks loom.**
- **The highly integrated sector accounts for 22% of total trade under the United States-Mexico-Canada Agreement (i.e. NAFTA 2.0), making it a valuable economic contributor and target in recent trade disputes.**
- **This time is no different. The incoming US President has threatened 25% tariffs on Mexican and Canadian imports on day one. While there will inevitably be carve-outs, the auto sector is currently caught in the middle.**
- **Likely regulatory and incentive changes for fuel efficiency standards and climate spending measures offer further uncertainty about the overall environment.**
- **A drawn out and retaliatory trade war may widen gaps between regional producers and international peers. North America's share of global automotive exports has already declined by more than 2% since 2015, while Asia-Pacific's share has grown by nearly 7%.**
- **Uncertainty may be the theme entering 2025, but opportunities for collaboration (particularly around critical minerals and electric vehicle supply chains) could yield substantial benefits for all three countries. The question is whether dialogue can be guided to this constructive place, which will likely require concessions from all parties.**

DISTURBANCE IN THE (MARKET) FORCE

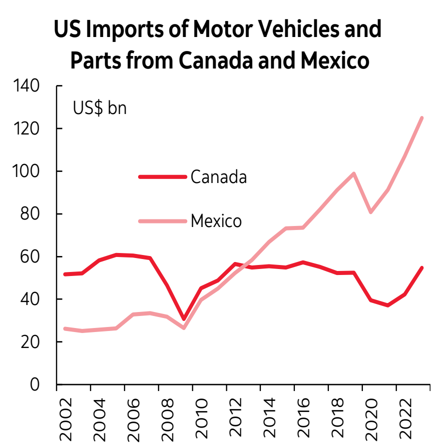
North America's automotive sector remains large and resilient, even in the face of recent challenges. Despite declines from historic highs in previous decades, the continent's automotive sector remains a significant economic contributor, accounting for roughly 25% of global light-duty automotive and 18% of vehicle production in 2023 (chart 1). It has also proven resilient. Following a myriad of supply and demand-related shocks after the pandemic (i.e. semi-conductor shortages, supply chain challenges, strikes, high interest rates, etc.), total production volumes across the continent have rebounded close

Chart 1



Sources: Scotiabank Economics, Wards Automotive.

Chart 2



HS codes 8701 to 8708.
Sources: Scotiabank Economics, US Census Bureau.

to pre-pandemic levels. With novel investment opportunities in electric and battery supply chains that have emerged, it should be a period of "full steam ahead" for North American automotive.

The benefits of this resilience accrue to all three countries, since automotive production across the continent is highly integrated (chart 2). The sector is arguably the poster child for the opportunities offered by free trade. The Office of the US Trade Representative **estimates** that total automotive trade (imports + exports of vehicle and parts) accounts for 22% of total trade under the USMCA, making it the largest component of total North American trade. Nearly 50% of US imports of motor vehicles and parts in 2023 came from Canada (15%) and Mexico (35%) (chart 3). The two partners are even more reliant on the US. The US is the export destination for 91% of Canadian automotive and automotive parts exports, and 84% of Mexican exports in the same categories (chart 3 again). The economic benefits of this interconnection are evident for all three parties. In the US, the auto sector accounted for roughly 8% of total private sector jobs in 2022. Manufacturing of motor vehicles and parts also accounted for 12% of total Canadian merchandise **exports** in 2023, and 3.6% of Mexican GDP.

Yet integration is a double-edged sword. As supply and demand shocks are finally clearing, policy and trade-related shocks hang on the horizon. Given the sector's scale and visibility, it is frequently at the forefront of trade discussions and tensions. Shifts in any one country or segment of the value chain tend to reverberate, for good or ill, through all three countries. This time is no different. The incoming US President has already threatened 25% tariffs on all Canadian and Mexican imports, and campaign threats have ranged from 10%–500%. Additional pledges include repealing/revoking environmental regulations and incentives, and highlighting specific tensions to discuss in the upcoming 2026 review of the United States-Canada-Mexico Agreement (USMCA, or NAFTA 2.0). There is enormous uncertainty as to whether these measures will be implemented, but even the **issuance** of threats alone is raising questions about impacts and the path forward, imposing new costs on sectors that have only recently seen high costs decline following a host of pandemic-related shocks.

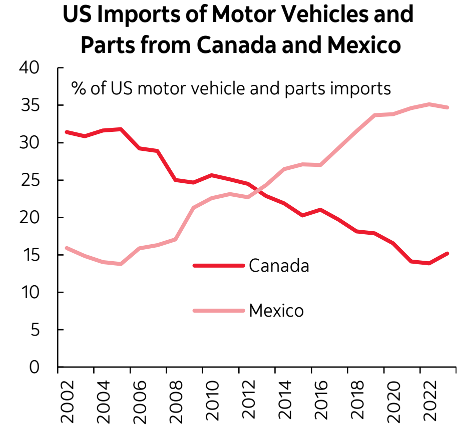
BRINGING A TIRE IRON TO A TRADE WAR

Looking to policy shocks, tariffs will likely be a recurring theme. In real terms, US tariffs on Canadian and Mexican automotive imports would mean higher import taxes on US $55 bn of Canadian automotive sector imports, and US $125 bn of Mexican automotive sector imports (2023 figures). The exact impacts of each will depend on the tariff rate, scope of coverage across sectors, and how long a given tariff might be in place. For example, previous tariffs on Canadian steel and aluminum led to high volumes of temporary disruptions, but export levels to the US for both materials had fully rebounded within 2–3 years of tariffs being lifted, even when accounting for pandemic effects. It should be stressed that both broad-based and targeted tariffs may also prove damaging to US firms. Mexico and Canada are the export destinations for the majority of US automotive parts, leaving US players vulnerable to retaliatory tariffs.

Mexico's growing relationship with China has been a point of contention for the incoming administration. Mexico imported US $114 bn from China in 2023, up from US$61 bn a decade ago (chart 4), and Mexico's trade deficit with the country is growing. Machinery, metals and transportation represent 75% of Mexican imports from China. Official US and Canadian concerns have centred around transshipment of Chinese goods through Mexico to gain preferential tariff access, Chinese companies setting up production facilities in Mexico for the same reasons, and the implications of these steps for securing legitimate and/or counterfeit certificates of origin.

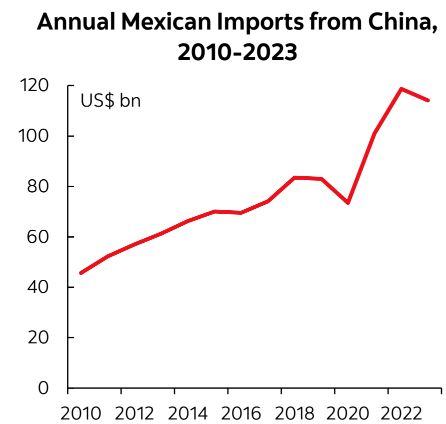
Demands and threats are already being issued, well before the scheduled 2026 review of the USMCA. The most recent justification for tariffs is linked to immigration and drug enforcement. This highlights a risk that legal clauses reserved for national security challenges will be invoked within trade disputes. It may also hint at what's ahead, as various clauses within the USMCA—cracking down on certificates of origin, calling for higher Labour Value Content requirements, removing the

Chart 3



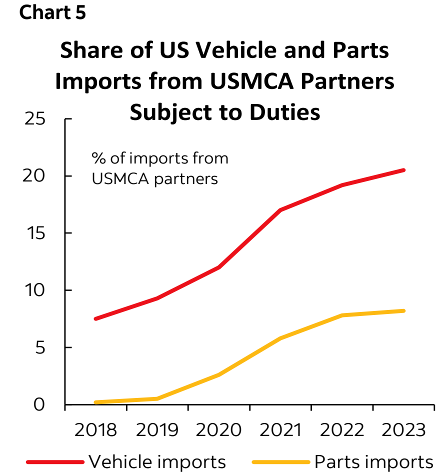
HS codes 8701 to 8708.
Sources: Scotiabank Economics, US Census Bureau.

Chart 4



Sources: Scotiabank Economics, INEGI.

Chart 5



Sources: Scotiabank Economics, Office of the US Trade Representative.

ability for Chinese-owned components to count towards Regional Content Value rules, etc.—could be leveraged to force concessions on both trade and non-trade related concerns.

An important caveat is that regardless of how negotiations end up, the automotive sector may not fully avoid tariffs. A significant number of Canadian and Mexican automotive producers are already paying tariffs in lieu of meeting rules of origin requirements specified under the USMCA (chart 5). This figure may continue to grow in time, particularly as electric vehicle deployments increase, given their current need to source refined minerals and battery components from other countries.

Beyond tariffs, threats to repeal regulations and incentives also throw the pace of electrification into question, adding additional uncertainties. Campaign threats to repeal "EV mandates" will likely result in changes to federal fuel efficiency regulations for automotive manufacturers. Under the Biden administration, standards were made stringent enough that compliance would have necessitated selling a large volume of electric or plug-in hybrid vehicles. If current schedules hold, this weakening of standards will likely take effect in 2027. Efforts may also be made to revoke a waiver permitting California to set its own vehicle emissions standards, which would further change regulatory standards for a market representing 12% of new light-duty vehicle sales in the US. Repealing the *Inflation Reduction Act*, a federal incentive package to subsidize clean energy and climate solutions, would likely also see the removal of federal EV subsidies to free up more funding for tax cuts (chart 6). These subsidies spurred over US $34 bn in EV manufacturing to bolster supply and led to US$87 bn in household and commercial spending for zero-emissions vehicles in 2023 (chart 7). Their repeal could create headwinds for both producers and consumers of low/zero emissions vehicles. Repeals and revocations will fuel uncertainty during a period where the trajectory of vehicle electrification is still heavily influenced by policy supports. Beyond the climate impacts, it could have effects on investment flows in the coming years. EV production accounted for almost one quarter of total US automotive manufacturing in 2023 (chart 8).

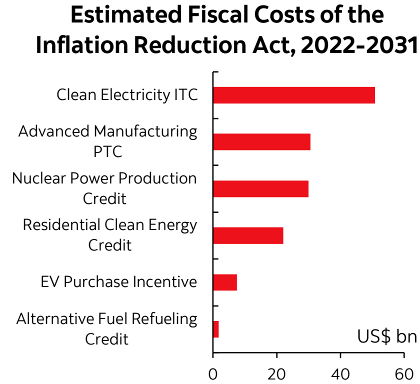
A pullback in America's climate ambitions could also impact Canada's path forward, given a fondness for alignment. Canada has historically aligned its fuel efficiency standards with the US and has publicly noted it will align with whichever fuel efficiency standards are most stringent (federal or state) moving forward. Uncertainty over both could lead to revisions in current plans. Additionally, shifts in American industrial policy could also have domestic effects in other countries. Canadian supports for EV manufacturing have been positioned as a response to US largesse, putting into question the rationale for maintaining major spending into climate and clean energy manufacturing capacity moving forward.

BRAKING ON A STRAIGHTAWAY

The biggest risk imposed on North American producers is that they could fall behind global competitors. Since 2015, the continent's share of global vehicle exports has declined by 2%, while Asia-Pacific's share has grown by nearly 7%. China's rise to being the largest global exporter by number of vehicles, driven by the country's expansive domestic supply chains, technology advantages, and growing global demand for Chinese vehicles, has played a key role in this. As other countries respond to Chinese vehicle production through a blend of tariffs and incentives for domestic production, supporting competitiveness for North American producers will remain critical. This will be more challenging if producers in all three countries pay higher tariffs, Mexico draws closer with China, and electrification investments are delayed due to policy shifts and tariff threats.

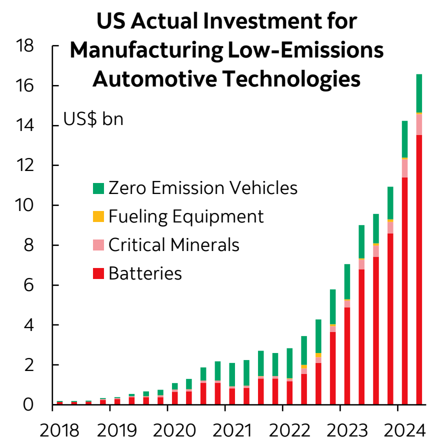
Turbulence is unlikely to make the plane go faster. "Uncertainty" may well be the theme of 2025, and the continent's automotive sector is ending this year with plenty of it. Opportunities for greater competitiveness and investment are abundant in all three countries, but they may not be realized if trade wars are pursued. Continued growth for North American producers is possible, and should remain the goal of all parties. Deeper, more integrated and forward-looking trade discussions can play a role in that, as well as in reducing supply chain risk, but only if leaders aiming to support the sector spend their time focused on growing the pie instead of obsessing over how to divide it. This will likely take concessions from all parties.

Chart 6



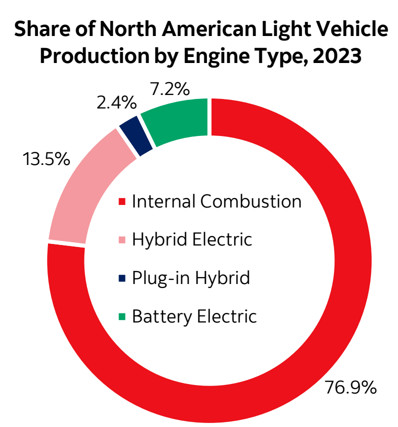
CBO estimastes seen above are notably lower than third party sources.
Sources: Scotiabank Economics, Congressional Budget Office.

Chart 7



Sources: Scotiabank Economics, Clean Investment Monitor.

Chart 8



Sources: Scotiabank Economics, Federal Reserve Bank of Chicago, S&P Global Mobility.