Senate Democratic Policy Committee Hearing

"An Oversight Hearing on Trade Policy and the U.S. Automobile Industry"

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I appreciate the opportunity to participate in this hearing and to convey results of analysis of the North American auto industry that is a part of my Institute's broader study of North American economic integration.

My comments this morning will draw on a new book coauthored with Gary Hufbauer, entitled "NAFTA Revisited: Achievements and Challenges," that was published in October 2005. I would like to submit the chapter on autos from that book in lieu of my written statement.

For the past four decades, trade agreements among the three countries of North America have contributed importantly to the regional integration of the auto industry. Disputes in the automotive sector launched the first postwar trade agreement between the United States and Canada—the 1965 Canada–United States Automotive Agreement (commonly known as the 1965 Auto Pact). Clearing up residual automotive trade and investment frictions was central to the 1989 Canada-US Free Trade Agreement (CUSFTA). Mexican auto reforms, begun in the late 1980s, were then deepened and codified in the NAFTA. Today, the North American automotive industry is more integrated than any other sector of the regional economy.

Motor vehicles and parts account for a larger share of intraregional trade in North America than any product sector. Three-way auto trade in 2003 was $125 billion, representing 20 percent of total trade among NAFTA partners. Between 1993 and 2003, the volume of NAFTA auto trade almost doubled, accounting for 18 percent of the total growth in NAFTA trade over this period.

Much of the trade increase can be attributed to specialization, as parts manufacturers and assembly plants have been reoriented to take advantage of economies of scale. As a result, supply lines for finished vehicles routinely cross national boundaries, as parts and assembly work is performed wherever it is most efficient.

What did NAFTA actually do? Since the 1965 Auto Pact and the CUSFTA essentially integrated auto trade between Canada and the United States, NAFTA's greatest contribution to the auto sector was to bring Mexico into the fold. NAFTA phased out purely national content requirements, but as a political price, it tightened the CUSFTA rules of origin and associated North American content requirements. NAFTA also phased out so-called trade-balancing requirements (a Mexican policy device) as well as tariff and nontariff barriers within the finished auto and parts trade. Phaseout periods of up to 10 years were granted to give the Mexican industry (including foreign-owned assembly plants) time to adjust.

The integration story belies concerns about "runaway plants" and the "giant sucking sound" that were prevalent during the initial NAFTA debate. The elimination of trade barriers and investment incentives has not prompted huge segments of the automotive industry to shut down in one North American location and move to another. Instead, we have seen an acceleration of the ongoing process of specialization and intra-industry trade—just like what happened in the wake of the 1965 Auto Pact.

That doesn't mean that employment is booming. In the auto industry, as well as the entire manufacturing sector, employment in the United States <u>and Mexico</u> is substantially below the late 1990s. Canada experienced a less severe decline in auto jobs since then as well. Canada is the only NAFTA country where auto and manufacturing employment are greater today than when NAFTA entered into effect.

Looking at declines in US employment, we found that technology and demand effects were far more important than developments in the Mexican industry. So as far as auto jobs are concerned, the fear of southward migration is vastly overstated.

What about the impact on US auto wages? Although autoworkers in the United States took home more dollars in 2002 than in 1993, the earnings gain of 24 percent only matched cumulative inflation of 24 percent over the same period. In other words, the real purchasing power of auto wages remained the same. For most US workers, by contrast, the 1990s was a decade when real wages increased. Autoworkers did not do as well, but the auto premium is still large: In 2002 the average autoworker's hourly compensation was $10.34 per hour above the average blue-collar manufacturing worker.

Mexican autoworkers earn only a fraction of US pay levels. After the peso crisis, the compensation cost for a Mexican autoworker was less than 10 percent that of a US autoworker. Since then, Mexican compensation has steadily risen, to 16 percent of US compensation in 2002.

US union leaders argue that Mexico is putting downward pressure on the earnings of US autoworkers. While this may be partly true, we found strong evidence for another explanation: that the wage premium paid to unionized autoworkers—the amount they earn in excess of the average for manufacturing workers—was compressed in the early 1990s largely as a result of US nonunion auto plants.

Dire forecasts as to the consequences of North American free trade for US workers have not been born out in the auto industry. Trade has allowed firms in each country to specialize in the areas of the auto industry where they are most efficient—to the benefit of all three countries. While North America is somewhat less self-sufficient in the auto sector today than a decade ago, it seems likely that in the absence of NAFTA far more auto jobs would have been lost to Asian and European competitors.

In terms of what should be done to restore the health of the US auto industry, our research shows that NAFTA has had positive, though limited, medicinal powers. Curing the industry's more chronic problems, particularly those related to health and pension costs, require domestic policy reforms and should be the primary focus of Congressional attention.