Auto Tariffs: More Than A Fender Bender

by Royce Mendes

It wasn't that long ago when it was commonplace to question whether President Trump could make good on his promises. But, so far, he's generally found ways to stay true to his word, and that's exactly what's so concerning about auto tariffs. There are quite literally carloads of reasons not to raise tariffs, but that might not mean much.

Crash Test

Trump does, however, have a handful of options in front of him. He could, of course, reasonably come to the conclusion that auto imports are not a national security threat and drop the issue. He's seen firm pushback from his own party and major businesses have raised significant red flags about the idea, but again that hasn't stopped him before.

In a more likely scenario, he could choose to raise tariffs, while granting a temporary exemption to Canada, hopefully for longer than was the case for steel and aluminum. That would actually boost US demand for all North American-made vehicles for as long as the exemption lasted. However, the uncertainty (Chart 1) surrounding whether or not there was another shoe to drop would act to further push investment away from Canada and into the US. Such a scenario would be a win-win for Trump and is, as a result, our base-case forecast.

But, while it would face considerable opposition in some US quarters, there's a non-zero probability that Canadian vehicles are also slapped with tariffs. If that's the case, it's actually better if everyone else is in the same boat.

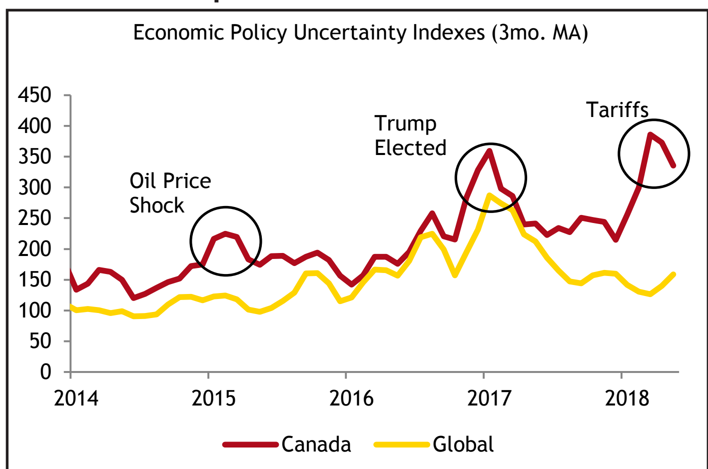
If all foreign-made cars faced a tariff, Americans would have a tougher time finding alternatives. However, if Canada were singled out, it wouldn't be too difficult for consumers to just avoid buying vehicles assembled north of the border. In other words, the elasticity of demand for Canadian-made autos in the latter case is higher.

Pinning down an estimate of elasticity for each scenario is an inexact science, but academic literature provides some guidance. We find that 25% tariffs on all foreign imports would see Canadian auto production fall by more than 400k units per year, while a tariff on only Canada would leave Canadian plants producing almost 900k fewer vehicles per year (Chart 2).

After also accounting for a 10% US tariff on parts, and the fact that reduced Canadian production would require fewer foreign inputs, we estimate the direct drag on GDP to be ½% and 1% respectively for each scenario. That doesn't take into account a resultant weaker Canadian dollar which would work to soften the blow, but a hit to confidence which could potentially seriously worsen the situation.

Chart 1

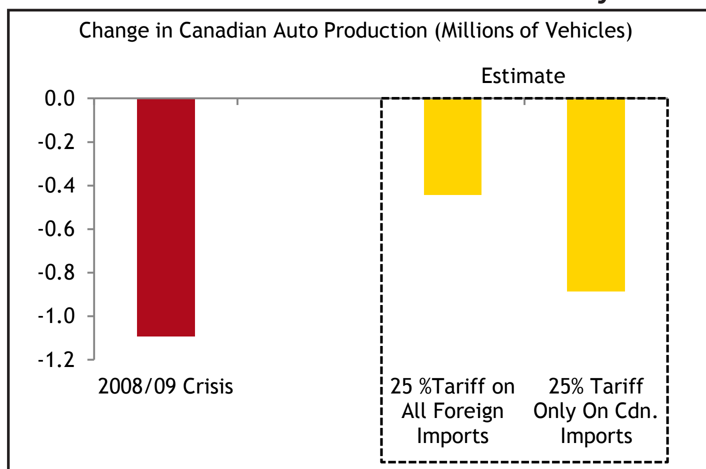
Canadian Economic Uncertainty in the Trump Era is Worse Than Expected At Time of Election



Source: Baker, Bloom & Davis, CIBC

Chart 2

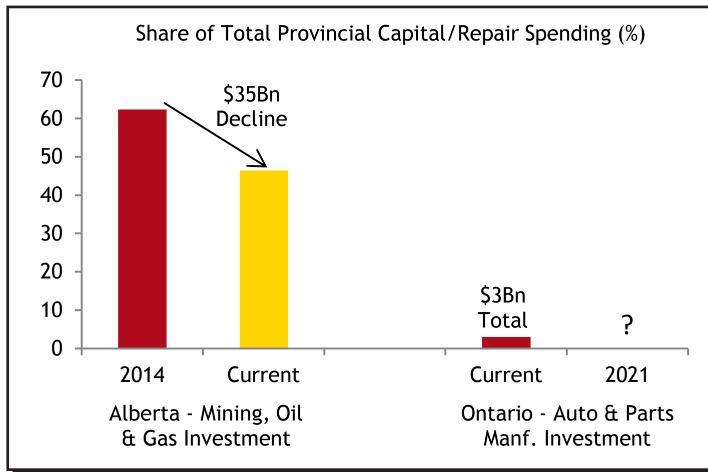
Auto Production Could Decline Dramatically



Source: Haver Analytics, CIBC

Chart 3

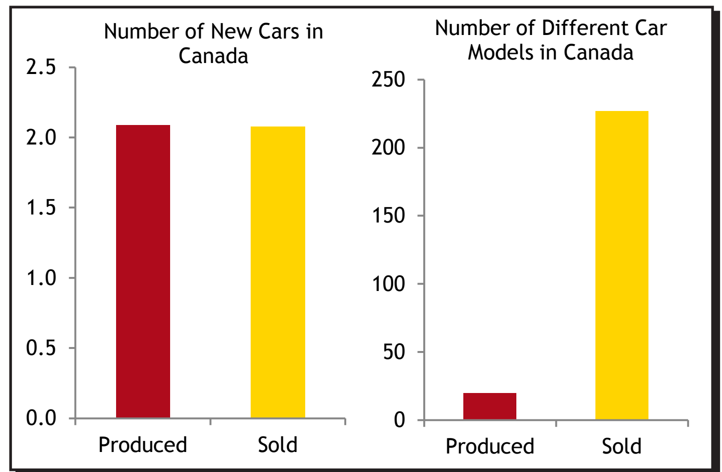
Short-Term Investment Impact Will Be Small



Source: Statistics Canada, CIBC

Chart 4

Cdn Production Equal Consumer Purchases (L); But is Limited to Very Few Models (R)



Source: Statistics Canada, CIBC

Of course, the vast majority of any decline would be concentrated in Ontario. Such a shock would likely throw the province into a mild recession, and depending on the speed at which production tails off, risk one at the national level as well.

However, unlike the recent provincial recession in Alberta, the slowdown won't be led by capital spending. Indeed, total business investment in the auto sector is miniscule when compared to even just the decline seen in the oil patch (Chart 3). The effect on the capital stock, and thereby Canada's potential output would more likely slowly rust away as additions to capacity swing to US locations and Canadian plants close.

Can Canadian Tariffs Protect the Auto Industry?

It's tempting to suggest that Canada could just raise its own tariffs and force Canadians to buy domestically produced vehicles. Looking at the number of cars produced in Canada relative to the almost exactly equal number of cars purchased by Canadian consumers indicates that notion could be the industry's saving grace (Chart 4, left). But, it has one major blind-spot.

Canada only produces a handful of models relative to the hundreds of choices to which consumers have become accustomed (Chart 4, right). Unless you believe someone looking to buy a flashy drop-top convertible sports car would be satisfied leaving their local car dealership with the keys to a minivan, it isn't a feasible solution to the potential problem at hand.

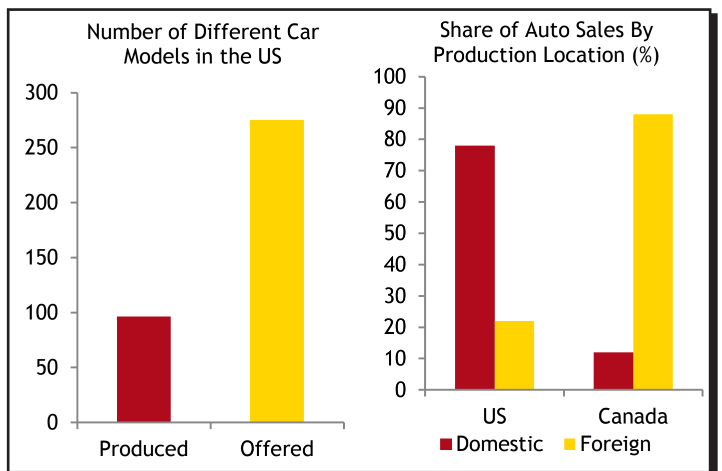
That applies to the US, but much less so. The US produces roughly a third of the models offered in America (Chart 5, left). But, more importantly, Americans are loyal customers. Domestically produced cars represented almost 80% of total US purchases last year, compared to the roughly 10% of Canadian purchases which were domestically produced, suggesting that Americans are at least somewhat better prepared to deal with import tariffs on cars (Chart 5, right).

No Such Thing As A Free Lunch

All this is not to say that tariffs are some sort of free lunch for American businesses and households. The US auto industry is already dealing with the recently introduced

Chart 5

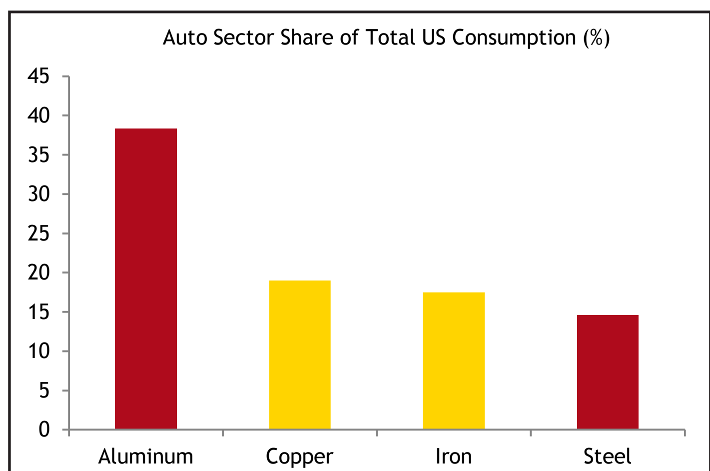
US Produces More Models (L) and Consumers Are More Loyal to Domestic Brands (R)



Source: Haver Analytics, APRC, CIBC

Chart 6

US Automakers Have Already Taken A Hit From Steel & Aluminum Tariffs



Source: Wards, CIBC

steel and aluminum tariffs, which make US producers less competitive (Chart 6).

Also, don't forget that US-made parts account for roughly 45% of vehicles assembled in Canada, so a reduction in Ontario activity would ripple across the border in the Great Lakes region. Import tariffs would raise domestic car prices too, as the industry is already facing near-term capacity constraints (Chart 7, left & right), not to mention hurting the American owners and employees of car dealerships involved in the sale of imported vehicles.

In the long-run, the US economy could reorient itself away from imported autos and further toward those produced domestically. But, in today's environment, when the economy is at full employment and capacity utilization rates are running high, it would require moving factory locations, reorganizing supply chains and pulling workers away from other industries, which could take years if not decades to fully work through the economy.

Retaliatory Tariffs Have a Blow-Back

Canada could respond to US auto tariffs with retaliatory duties on non-auto American-made goods. While that would be aimed at upping the pressure on the US side to reach a negotiated settlement, it would have some negative consequences for Canada's domestic economy.

The tariffs already applied in response to America's action on metals won't only lift prices for some consumer goods. Indeed, roughly half of those new tariffs are being applied to intermediate goods (Chart 8). That risks raising input costs for Canadian goods producers, a self-inflicted wound that could add to job losses and shuttered factories.

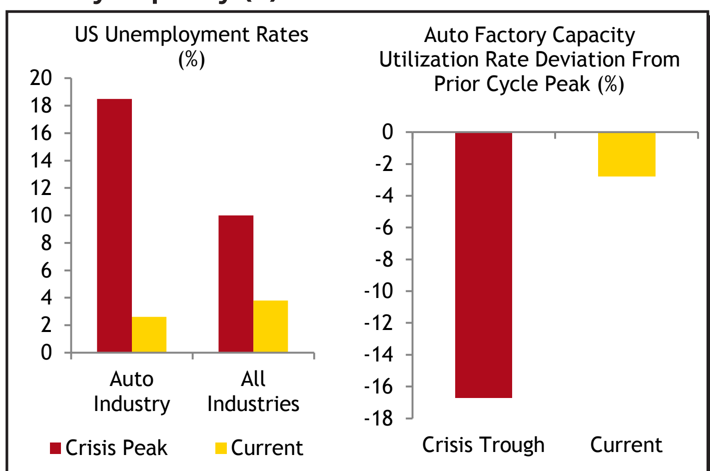
Policy Implications

It's clear then that even in our base-case scenario, in which auto tariffs are threatened but delayed, policymakers need to provide some support. For the Bank of Canada, a cautious approach to raising rates is warranted.

For the federal government, support for firms and workers adversely affected by tariffs, makes sense. But the negatives from the all out trade war that US auto tariffs would engender are too large to ignore. With a weaker negotiating hand, Canada may have to offer a few concessions in order to push NAFTA negotiations across the finish line before auto tariffs hit.

Chart 7

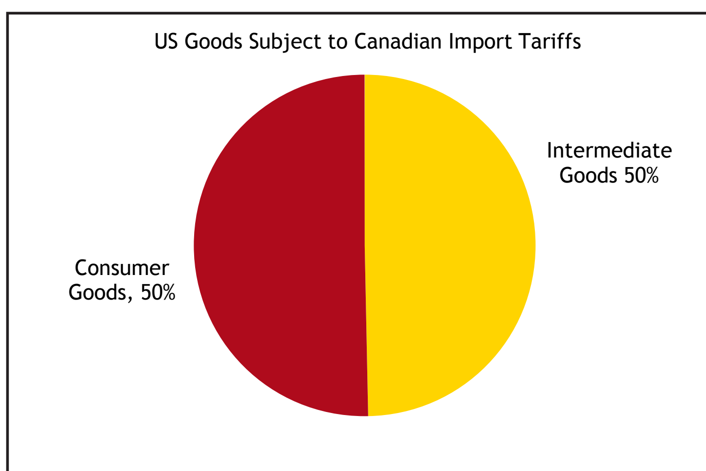
Dwindling Supply of US Auto Workers (L) and Factory Capacity (R)



Source: BLS, FRB, CIBC

Chart 8

Half of Canadian Retaliatory Tariffs on US Products Aimed at Intermediate Goods



Source: US Census Bureau, CIBC