Canadian Centre for Policy Alternatives
May 2014

CETA and Canada's Auto Industry

Making a Bad Situation Worse

Jim Stanford

www.policyalternatives.ca RESEARCH ANALYSIS SOLUTIONS

CCPA
CANADIAN CENTRE
for POLICY ALTERNATIVES
CENTRE CANADIEN
de POLITIQUES ALTERNATIVES

CCPA
CANADIAN CENTRE
for POLICY ALTERNATIVES
CENTRE CANADIEN
de POLITIQUES ALTERNATIVES

ISBN 978-1-77125-108-2

This report is available free of charge at www.policyalternatives.ca. Printed copies may be ordered through the CCPA National Office for $10.

PLEASE MAKE A DONATION...

Help us to continue to offer our publications free online.

With your support we can continue to produce high quality research—and make sure it gets into the hands of citizens, journalists, policy makers and progressive organizations. Visit www.policyalternatives.ca or call 613-563-1341 for more information.

The CCPA is an independent policy research organization. This report has been subjected to peer review and meets the research standards of the Centre.

The opinions and recommendations in this report, and any errors, are those of the authors, and do not necessarily reflect the views of the funders of this report.

UNIFOR
Local 567

ABOUT THE AUTHOR

Jim Stanford is economist at Unifor, the largest union in Canada's private sector, formed through the merger in 2013 of the Canadian Auto Workers and the Communications Energy and Paperworkers' union. He has 20 years of experience in auto industry analysis; he completed his Ph.D. dissertation on international trade theory and policy.

ACKNOWLEDGEMENTS

The author kindly thanks Scott Sinclair, John Jacobs, Bill Murnighan, and Angelo diCaro for very helpful comments on earlier drafts of this work.

5 **Summary**

9 **Current Canada-EU Automotive Trade**
9 Trade Data (Values)
12 Vehicles Imported to Canada From Europe
14 What Vehicles Does Canada Export to Europe?
20 Foreign Direct Investment
22 Macroeconomic Factors

25 **Reported Automotive Provisions of the CETA**
26 Locking in a Huge Deficit
28 Incremental Impacts of Tariff Elimination
29 Impact on Investment Decisions
31 Rules of Origin Derogation

34 **Conclusions and Recommendations**

37 **Notes**

Summary

DESPITE ITS RECENT challenges, Canada's automotive manufacturing sector still plays a vital and disproportionate role in Canada's national economy. The sector produces Canada's second-largest flow of exports (after petroleum products), and is our largest manufacturing industry (by value-added). Its superior productivity and income generating potential, and strong spillover linkages, mean that hundreds of thousands of Canadians depend — directly or indirectly — on its success.

A major factor in the auto industry's recent challenges has been a sharp deterioration in Canada's automotive trade performance since the turn of the century. Canada used to enjoy a significant trade surplus (concentrated in net exports of finished vehicles). But in the face of globalization, the implementation of NAFTA, the rising Canadian dollar, and other factors, that surplus disintegrated into a large annual automotive deficit (that exceeded $18 billion in 2013) that has undermined domestic production and employment. With the U.S., our bilateral automotive trade is substantial, two-way, and broadly balanced. But with every other auto-producing jurisdiction — including Europe — Canada's auto trade is precariously unbalanced, consisting mostly of large import flows (but almost no exports going in the other direction). The growth of Canada's auto trade deficit with the EU (which reached an all-time high of $5.3 billion in 2013) has thus contributed notably to the Canadian industry's recent tribulations.

Unfortunately, the proposed CETA will cement that damaging imbalance — and in fact will make things incrementally worse. Automotive im-

ports from Europe (consisting primarily of higher-end finished vehicles) are currently 21 times the value of our exports to Europe (which consist mostly of auto parts). The resulting trade deficit drained over $5 billion of purchasing power from the Canadian economy in 2013; the bilateral auto deficit has more than doubled since the turn of the century. European brands hold a significant share of the Canadian market (10% in 2013, twice as high as a decade earlier), with an extensive dealer network and high brand recognition among Canadian consumers. Last year almost 120,000 vehicles were imported to Canada from the EU. In contrast, Europeans buy almost no Canadian-made vehicles (likely less than 5,000 per year). Global automakers (including those with Canadian production facilities) overwhelmingly serve their European customers from their own European plants. Other than niche demand for iconic North American vehicle types (such as muscle cars and minivans), there is little reason to expect Europeans to purchase more Canadian-made vehicles. In contrast, European automakers have no assembly facilities in Canada; there is no link between their Canadian sales, and Canadian manufacturing activity. In the auto parts sector, most factories tend to locate near final assembly plants in order to optimize logistics and transportation costs, so there will be little impact in either direction from tariff reduction on the location of auto parts production.

Mutual tariff elimination will not alter this fundamental structural asymmetry in our automotive trade with Europe. Indeed, a free trade agreement will lock in the current unbalanced situation, by granting unrestricted market access to European automakers regardless of the size of the resulting trade imbalance. Export flows in both directions can be expected to increase modestly after a trade deal, but the absolute size of that increase will be much larger for European sales to Canada (by virtue of their superior starting position in our market). Consequently, we expect the bilateral automotive trade imbalance to widen after a Canada-EU trade deal, likely to at least $7 billion per year within a decade. Macroeconomic factors will exacerbate this negative outlook. Particularly damaging in this regard will be the impact of the depreciated euro (relative to the Canadian dollar) and the impact of European austerity measures on consumer demand in that continent for several more years to come. The incremental erosion in net demand for Canadian-made automotive products resulting from a CETA (potentially combined with the effects of other future trade deals with other automotive exporters, like Japan and Korea) will inevitably undermine, in an unpredictable manner, the business case for future investment and employment in Canadian facilities.

A unique provision of the CETA would allow for a "derogation" of domestic-content provisions applied to Canadian vehicle exports, in recognition of the integrated continental nature of the automotive supply chain in North America. Canada will be allowed to export up to 100,000 vehicles per year at preferential tariff rates, with only 20 percent domestic content (rather than the normal 50 percent rule of origin). This provision has been widely misinterpreted. It is not an "advantage" for Canada, it does not represent an expansion of a European "quota" on imports from Canada, and it certainly does not imply that Canada will indeed export 100,000 vehicles per year to the EU. This provision is intended solely to address the asymmetric impact (to Canada's disadvantage) of the traditional approach to rules of origin; EU negotiators have in fact described the derogation provision as being mostly of symbolic importance. The lack of market foothold, lack of brand awareness, and general lack of interest by Canadian-based automakers in exporting from Canada to Europe all indicate that the increase in Canadian vehicle exports to the EU will be marginal — even if the EU tariff is removed, and even if Canadian-made vehicles do not have to meet the same domestic content threshold as European-made vehicles.

This paper is organized into three main sections. First it will review the current status of bilateral automotive trade and investment relationships between Canada and the EU. Second, the paper describes the automotive features of the proposed CETA (insofar as they have been reported, keeping in mind that the Canadian government has not publicly released the full text of the proposed deal), and considers their likely effects on Canadian automotive trade, investment, and employment. The paper concludes with an overall analysis of CETA's effects, and makes several concrete recommendations regarding how the CETA could be altered so as to be less damaging to this key export industry. Those recommendations include:

- The Canadian government should prepare a detailed statistical inventory on Canadian-made vehicles currently exported to Europe, and survey automakers producing in Canada regarding the opportunities for market growth in Europe for their products, in the event of the elimination of EU tariffs on automotive products. Right now our government does not even know what vehicles, or how many, Canada actually exports to Europe, and hence it is impossible to take seriously the government's claim that the CETA will provide a major boost to Canada's auto industry.

- The Canadian government should provide specific supports for automakers producing in Canada, to assist them in developing offshore market opportunities in general, and sales to the EU in particular (including export-oriented transportation infrastructure, subsidies for the development of export-oriented features, and support for overseas marketing).
- As a condition of tariff elimination on vehicle exports to Canada, the Canadian government should require European automakers to invest in Canadian production opportunities (either independently, or through joint venture arrangements with other firms), in vehicle assembly, parts manufacturing, or other production offsets.
- A condition of the implementation of a CETA should be a mutual understanding between the two parties regarding an appropriate valuation for their respective currencies, and a prohibition of policy efforts aimed at attaining a competitive advantage through deviation of the exchange rate from its underlying fair value.

Current Canada-EU Automotive Trade

Trade Data (Values)

Table 1 summarizes current bilateral automotive trade between Canada and the EU, on the basis of data reported in Industry Canada's Strategis database. The data is disaggregated into the three major sub-sectors of automotive manufacturing: assembled passenger vehicles (NAICS industry code 3361), truck and bus bodies and trailers (3362), and motor vehicle parts (3363). The table reports annual trade flows (for each product category, in both directions) for the three most recent years.

In 2013, Canada imported a total of $5.6 billion in automotive products from Europe, the highest ever. Over three-quarters of this total ($4.3 billion) represented finished vehicles; most of the rest consisted of auto parts.[1] Going the other way, Canada exported $263 million in total automotive products to the EU in 2013. Almost eighty percent of this total was parts; exports of finished vehicles equaled only $46 million. The resulting bilateral trade deficit for Canada equaled $5.34 billion (once again, the worst ever). Automotive products accounted for over one-quarter of Canada's total merchandise trade deficit with Europe last year (which swelled to over $20 billion).

A measure of the imbalance in the bilateral flow can be generated by computing the ratio of imports from the EU, to Canadian exports flowing back the other way. This imbalance ratio equaled 21.4 in 2013, and has been

TABLE 1 Bilateral Trade in Automotive Products, Value, Canada-EU, 2011–13 ($ millions)

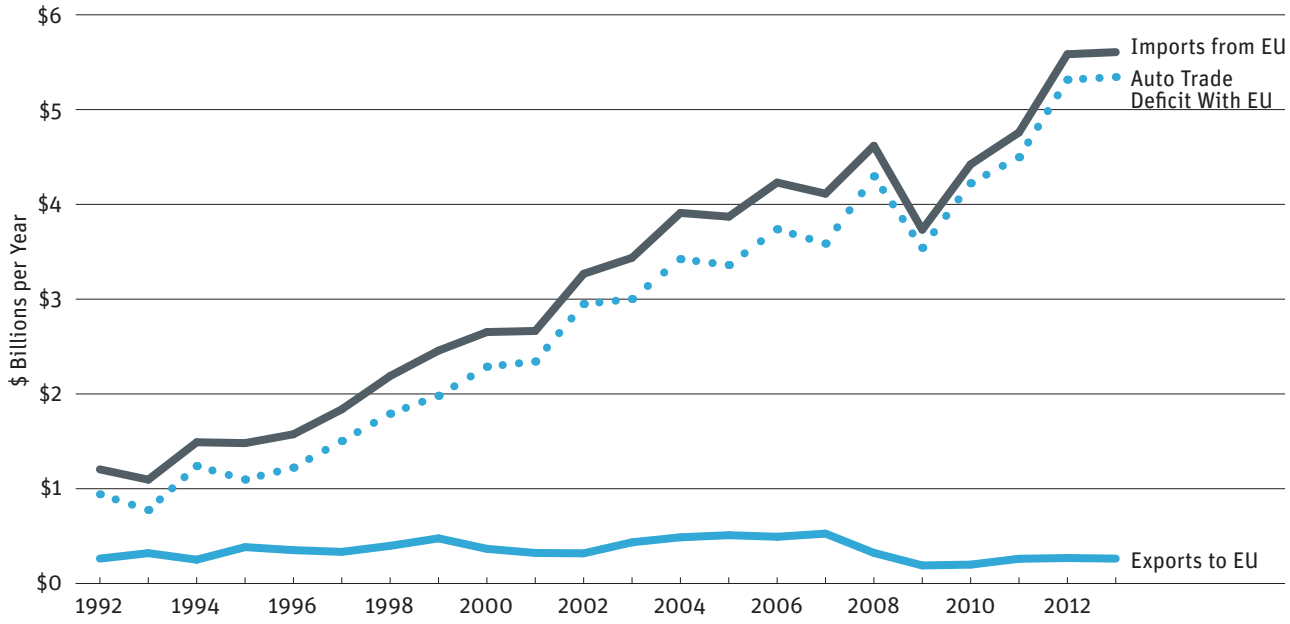
	2011	2012	2013	Change from 1999
Assembled Vehicles				
Exports to Europe	$56.4	$75.5	$46.3	-83.2%
Imports from Europe	$3,654.6	$4,279.6	$4,256.9	148.3%
Balance	-$3,598.2	-$4,204.1	-$4,210.6	
Ratio Imports to Exports	64.8	56.7	91.9	
Auto Parts				
Exports to Europe	$177.7	$181.3	$207.3	9.0%
Imports from Europe	$1,069.3	$1,269.3	$1,319.2	83.8%
Balance	-$891.6	-$1,088.0	-$1,111.9	
Ratio Imports to Exports	6.0	7.0	6.4	
Truck and Bus Bodies				
Exports to Europe	$26.7	$12.1	$8.9	-19.0%
Imports from Europe	$34.8	$35.3	$30.0	20.2%
Balance	-$8.1	-$23.1	-$21.1	
Ratio Imports to Exports	1.3	2.9	3.4	
All Auto Products				
Exports to Europe	$260.8	$268.9	$262.5	-44.9%
Imports from Europe	$4,758.7	$5,584.1	$5,606.1	128.2%
Balance	-$4,497.9	-$5,315.2	-$5,343.6	
Ratio Imports to Exports	18.2	20.8	21.4	

Source Unifor Research from Industry Canada Strategis database.

getting worse in recent years. The measure of imbalance is especially severe for finished vehicles: in 2013, Canada imported 92 times as much finished vehicles from the EU (measured by value), as we exported to that market.

The last column of *Table 1* reports the change in each annual trade series to 2013 from 1999 (which was the year Canada's automotive manufacturing sector reached its historic peak of production). Canada's total automotive exports to the EU since 1999 have fallen by 45%. Our exports of finished vehicles declined by 83 percent during that time. In contrast, Canada's imports of automotive products from the EU have increased by 128% since 1999. The fastest growth has been in finished vehicles (which grew almost 150%), while imports of parts grew by 84%.

FIGURE 1 Bilateral Auto Trade With the EU

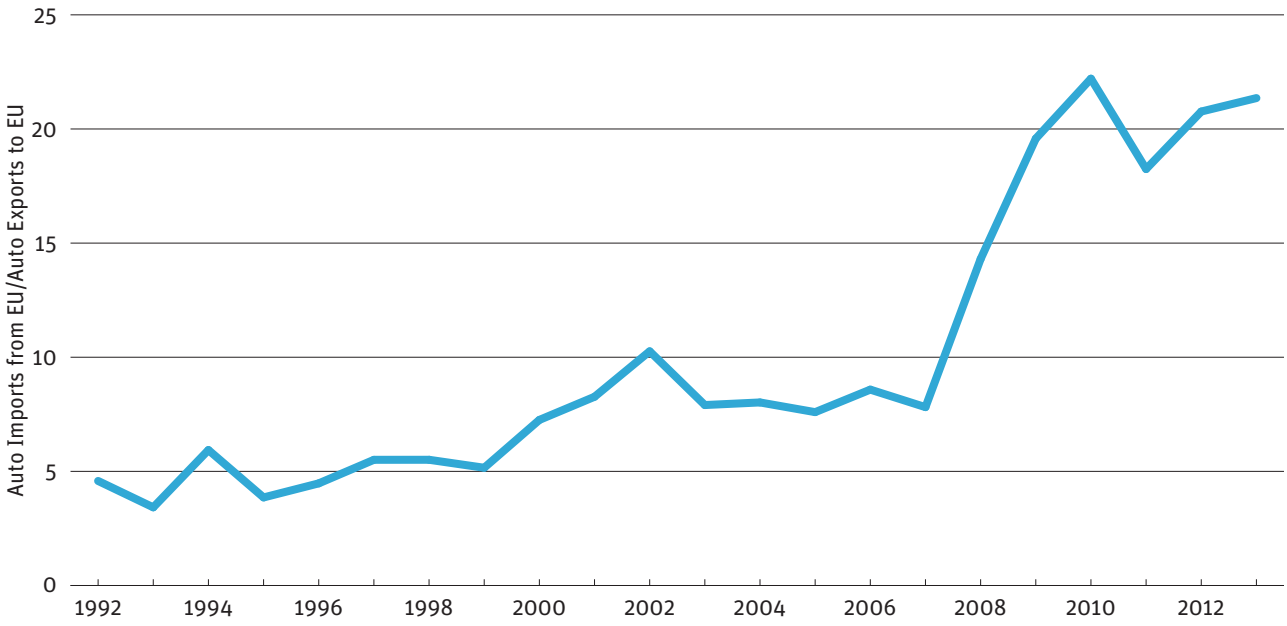


Source Unifor Research from Industry Canada Strategis database.

Figure 1 illustrates these sharply contrasting trends in the evolution of bilateral trade flows. Beginning in the late 1990s, European exports to Canada began to increase rapidly. Canada's exports to the EU, however, while never large to begin with, actually have declined by about half. This decline has accelerated in the years since the global financial crisis hit several European countries badly, suppressing consumer confidence and purchasing power. The growth of Canada's bilateral automotive trade deficit with Europe has closely paralleled the rise of Europe's exports to Canada (since the offsetting value of Canadian exports going the other way has diminished over time, as the trade flow became increasingly one-way in nature).

Figure 2 illustrates the historic evolution of the measure of the imbalance in bilateral trade computed above (equal to the ratio of Canada's automotive imports from the EU, to our exports going the other way). Until the late 1990s, this ratio equaled about 5-to-1. Canada's automotive exports to Europe were small, but not invisible in relation to imports coming the other way. Beginning around the turn of the century, the ratio of imbalance began to increase dramatically, and then really took off after 2007. The ratio reached over 20-to-1 by 2009 (where it has stayed since). This reflects both the significant increases in Canadian market share attained by major Euro-

FIGURE 2 Imbalance of Imports to Exports, Canada-EU Auto Trade



Source Unifor Research from Industry Canada Strategis database.

pean brands (such as Mercedes, BMW, Volkswagen, Audi, and others), and the erosion of Canada's already-small exports going the other way. The explosion of this imbalance reflects the deep decline in the European auto market after the financial crisis, and the long-run expansion of the market share in Canada of European-branded vehicles.

Vehicles Imported to Canada From Europe

The preceding discussion described Canada's bilateral automotive trade with the EU on the basis of aggregate values. For trade in finished vehicles, it is also important to understand the respective flows in terms of the types of vehicles imported or exported, and the number of units. This analysis can be conducted precisely for vehicles imported from Europe to Canada, thanks to detailed industry data regarding models sold in Canada. It is more difficult to develop an equally detailed portrait of Canada's (much smaller) vehicle exports to Europe, due to an unavailability of comparable data.

Table 2 reports data on sales in Canada in 2013 of light vehicles (including passenger cars, light trucks, SUVs, and vans) assembled in the EU. The

TABLE 2 Canadian Vehicle Imports from the EU, Units, 2013

Brand	Models	Quantity
Audi	A3, A4, A5, A6, A7, A8, R8, TT, Q5, Q7	20,506
BMW	1-Series, 3-Series, 4-Series, 5-Series, 6-Series, 7-Series, Z4, X1, Mini Cooper, Mini Countryman, Mini Paceman	26,612
Ford	Transit Connect	3,859
General Motors	Buick Regal*	5
Jaguar/Land Rover	F-Type, XF, XJ6/8, XK8, Evoque, LR2, LR4, Range Rover, Range Rover Sport	6,399
Mercedes/Daimler	B-Class, C-Class, E-Class, S-Class, SL, SLK, SLR, SLS, Maybach, Smart, G-Class, GLK, Sprinter Van	29,688
Porsche	911, Boxster, Cayman, Panamera, Cayenne	3,680
Vokswagen	CC, Eos, Golf, GTI, Tiguan, Touareg	22,671
Volvo	30-Series, 60-Series, 70-Series, 80-Series, XC60, XC70, XC90	4,673
EU Total		**118,093**

Source Unifor Research from Ward's Automotive data, based on Canadian sales of European-made vehicles during 2013 year.
***** Buick Regal is now manufactured in Canada.

data are attained from the detailed sales reports published by *Ward's Automotive*, a leading industry data source, and are comprehensive — covering all new vehicles sold in Canada that year. A total of 118,093 EU-manufactured vehicles were sold in Canada in 2013, representing just under 7% of all new vehicles sold in Canada that year. (Counting vehicles produced in North America by the European-based automakers, the total market share of European-branded vehicles reached 10% of Canadian sales in 2013, double its share a decade earlier.) The number of vehicles imported from the EU has grown by 37 percent since 2009. The leading importers (in order of size) were Mercedes/Daimler, BMW, Volkswagen, and Audi. Two North American producers (Ford and GM) also imported finished vehicles from Europe in 2013 — although the sole model GM has imported from Europe in recent years (the Buick Regal) is now produced in Canada, so that import flow has dried up.[2]

If we compare the number of EU-made vehicles sold in Canada, to the aggregate value of the finished vehicle import flow (reported in *Table 1*), we attain an apparent per unit value of just over $36,000. Keep in mind this is the wholesale import price (not including transportation in Canada, duties, and dealer margins); average final unit prices paid by Canadian consumers for these EU-made vehicles are generally higher than that. This confirms that the imports of EU-made vehicles are concentrated in higher-end segments of the passenger vehicle market. The strong market position of European automakers in luxury vehicle segments drives their penetration of

Canada's market. Price and cost are less important selling features for these models (compared to other segments of the vehicle market), hence they can be profitably assembled in high-cost European plants[3] — although price factors can still incrementally affect their attained market share.

What Vehicles Does Canada Export to Europe?

Unfortunately, equally precise data regarding exports of Canadian-made vehicles to the EU are not publicly available. Industry data (from *Ward's Automotive* and other sources) regarding vehicle sales in Europe does not disaggregate model-by-model sales with the same detail as they do for North American sales (and hence do not allow a bottom-up summary of EU sales of Canadian-made vehicles, symmetrical to the data reported in *Table 2*). *Ward's Automotive* does publish a partial inventory of offshore exports (to destinations outside of NAFTA) of vehicles made in the U.S. and Canada, based on a compilation of shipping data from North American ports. This data as it applies to Canadian-made vehicles is summarized in *Table 3*. It is not complete, however; for example, the *Ward's* data does not report offshore sales for one major Canadian producer (Chrysler).[4] Also, for vehicles which are assembled in more than one location in North America, there is no way to distinguish whether Canadian-produced or U.S.-produced units were exported.[5]

Data on Canadian offshore vehicle exports from this *Ward's Automotive* source are summarized in *Table 3*. Total offshore exports of Canadian-made vehicles totalled over 75,000 vehicles in 2012 (most recent year available). This represented just over 3% of all Canadian vehicle assembly in 2012. The most highly-exported Canadian-made vehicle was the Ford Edge (assembled in Oakville), of which over 32,000 units were exported offshore in 2012 (representing about 18% of that vehicle's total output in the year).

However, according to this source, very few of Canada's offshore vehicle exports were destined for Europe. Only 3% of Canadian offshore exports were identified as destined for the EU. In fact, according to *Ward's*, only a single Canadian-made vehicle was exported to the EU in 2012: the Chevrolet Camaro, assembled in Oshawa. (Ironically, GM has recently announced its intention to shift production of this vehicle to a U.S. plant beginning in 2015 — and the company also recently announced that it will no longer market the Chevrolet brand in Europe at all.[6]) Total offshore exports of the Camaro

TABLE 3 Offshore Exports of Canadian-Assembled Vehicles, Units, 2012

	EU	Other Europe	Other Offshore*	Total
Chrysler				
	na	na	na	na
Ford				
Crown Victoria	0	0	3	3
Lincoln Town Car	0	0	2	2
Edge	0	80	32,472	32,552
Flex	0	0	2,404	2,404
Lincoln MKT	0	0	435	435
Lincoln MKX	0	0	2,286	2,286
General Motors				
Camaro	2,392	90	3,821	6,303
Terrain	0	0	3,225	3,225
Honda				
Civic**	0	0	11,509	11,509
CR-V**	0	390	7,251	7,641
Acura MDX	0	0	1,489	1,489
Acura ZDX	0	0	244	244
Toyota				
Corolla**	0	30	6,903	6,933
Rav-4	0	0	3	3
Lexus RX	0	0	3	3
Total	**2,392**	**590**	**72,050**	**75,032**

Source Unifor Research from Ward's Automotive data. Ward's does not report offshore exports by Chrysler Corp.
* Includes Latin America other than Mexico.
** May include units produced at U.S. plants.

equaled 6,300 in 2012 — or 6% of total production that year. Just under 2,400 of those units were destined for the EU.

Table 3 underestimates Canada's total vehicle exports to the EU. It does not include Canadian-made Chrysler products that may be sold in Europe, and may not accurately capture the final destination of other offshore Canadian exports. By how much *Table 3* underestimates Canadian vehicle exports to the EU is unknown.

The Canadian government has released data indicating that Canada exported over 10,000 vehicles to the EU in 2012, and an average of over 8,000 cars per year between 2007 and 2012.[7] In response to requests for details and sources, the Department of Foreign Affairs, Trade and Development (DFATD) has provided a breakdown of these estimates, which is summarized in *Table 4*. The data is sourced to Eurostat (the EU's governmental statistical agency), and was accessed through the World Trade Atlas (a commercial global trade database service). The data is disaggregated into the eight 6-digit harmonized tariff code categories which represent passenger vehicles of various makes and engine displacements. These include categories 870221 through 870224 (representing vehicles with conventional piston spark-ignition engines of increasing sizes), 870331 through 870333 (representing vehicles with diesel engines of increasing sizes), and 870390 (a catch-all category including "vehicles not elsewhere specified"). For each year 2007 through 2012 (the years covered by the DFATD data), *Table 4* reports EU imports of Canadian-made vehicles by tariff category, and also the average unit value of those flows (based on corresponding data, not reprinted in *Table 4*, on the total value of those imports, also as reported by Eurostat via the World Trade Atlas).

Several interesting features of the data cited by DFATD (and summarized in *Table 4*) should be noted. First, the data seem to imply tremendous volatility in the composition of EU imports of Canadian-made vehicles across those various categories. In 2007 and 2008, vehicles with very small conventional engines (under 1 litre) made up the vast majority of apparent Canadian exports; more recently, vehicles with large diesel engines made up the vast majority of apparent Canadian exports. This volatility is curious and hard to understand (given that automakers typically make long-term investments in dealer networks, advertising, etc., to build up sales of a particular vehicle over time). There are also anomalies in the apparent unit value of EU imports of Canadian-made vehicles. For the three smaller categories of vehicles with conventional engines (under 1 lite, 1.0–1.5 litres, and 1.5–3.0 litres) apparent unit prices fluctuate substantially from year to year, and are often very low (under $10,000 per vehicle in most years, as low as $4,000 per vehicle for some categories in some years).[8] This does not seem reasonable given the composition of Canada's vehicle manufacturing footprint: which is concentrated in larger passenger cars, SUVs, CUVs, and minivans, all of which have unit values, even at the wholesale level, far higher than $10,000 per vehicle.[9] These curious features suggest the possibility of cod-

TABLE 4 DFATD Estimates of Canadian Vehicle Exports to the EU, 2007–12

Harmonized Code	Engine Size		2007	2008	2009	2010	2011	2012	6-Year Total
Conventional Engine									
870321	Under 1 l	Units	8,629	4,699	1,364	567	462	1,835	17,556
		Unit Value	$7,863	$7,263	$6,209	$6,802	$7,374	$10,235	$7,775
870322	1-1.5 l	Units	153	28	41	33	17	14	286
		Unit Value	$4,077	$10,195	$10,927	$8,290	$6,775	$11,635	$6,675
870323	1.5-3 l	Units	956	1,499	817	642	382	660	4,956
		Unit Value	$9,606	$10,611	$12,082	$11,305	$9,253	$20,247	$11,928
870324	Over 3 l	Units	2,271	2,859	1,641	1,609	1,572	1,828	11,780
		Unit Value	$20,187	$19,460	$20,626	$19,714	$26,062	$28,914	$22,145
Diesel Engine									
870331	Under 1.5 l	Units	10	4	64	90	9	9	186
		Unit Value	$24,021	$14,170	$21,652	$24,337	$26,319	$36,506	$23,862
870332	1.5-2.5 l	Units	48	30	72	43	16	12	221
		Unit Value	$23,543	$11,101	$20,054	$21,621	$8,898	$20,174	$19,100
870333	Over 2.5 l	Units	81	68	177	2,464	5,570	5,629	13,989
		Unit Value	$30,353	$28,779	$22,600	$20,154	$24,848	$26,031	$24,520
Vehicles Not Elsewhere Specified									
870390	All	Units	7	21	14	12	18	35	107
		Unit Value	$24,619	$320,998	$4,128	$54,154	$5,193	$16,909	$77,628
Total Vehicles									
Units			**12,155**	**9,208**	**4,190**	**5,460**	**8,046**	**10,022**	**49,081**
Unit Value			**$10,490**	**$12,494**	**$14,206**	**$17,681**	**$23,229**	**$23,234**	**$16,674**

Source Department of Foreign Affairs, Trade and Development (via Eurostat and World Trade Atlas).

ing or measurement errors in the DFATD data (originating either from Eurostat or from the private World Trade Atlas service).

The sudden importance of vehicles with large diesel engines in reported EU vehicle imports from Canada since 2010 (tariff category 870333 accounts for 58 percent of all reported EU imports from Canada in 2010–12, but just 1 percent of the total for 2007–09) is especially curious. A few Canadian plants do manufacture diesel versions of specific models; but these account for a small share of total Canadian output. This makes it hard to match the apparent trade flows reported in *Table 4*, with a concrete understanding of exactly

which Canadian-made vehicles are being sold in Europe. In response to inquiries to DFATD for more concrete detail on exactly which Canadian-made vehicles are sold in Europe (as represented by the data contained in *Table 4*), Canadian officials replied that other than 6-digit tariff category data, they have no way of knowing what Canadian-made vehicles are sold in the EU. In practice, it would require concrete industry-level research and detailed interviews with Canadian firms in order to compile a complete and reliable picture of Canada's existing vehicle exports to Europe—a task which has evidently not been completed.

Even at the more "anonymous" level of 6-digit trade data, however, the Eurostat data used by DFATD is suspect. Canada's own statistical agency, Statistics Canada, also reports data on trade flows according to 6-digit tariff categories. It is possible to replicate *Table 4*, but using Canadian data on vehicle exports to the EU rather than EU data on vehicle imports.[10] The Statistics Canada version of the same 6-digit tariff category data is provided in *Table 5*. The figures are very different than the Eurostat data cited by DFATD, in several ways. First, the overall flow of Canadian-made vehicle exports to the EU is much smaller than reported in the Eurostat data: showing just one-third as many vehicles exported in 2012 (3,337, compared to the 10,000 reported by Eurostat). The total value of vehicle exports was much smaller, too: $92 million in 2012 (much closer to the Industry Canada data for 2012 reported in *Table 1*), instead of $233 million from Eurostat. In addition, the apparent composition of Canadian vehicle exports across tariff categories is more stable in the Statistics Canada data, and more concentrated in the vehicles with large conventional engines which we know are the mainstay of the Canadian industry. According to Statistics Canada, less than 1 percent of total vehicle exports to Europe over the entire 2007–12 period consisted of vehicles with diesel engines, and there was no "surge" in diesel vehicle exports visible in the latter years (a sharp contrast to the Eurostat data, which reported a dramatic increase in EU imports of Canadian-made diesel vehicles). In the Statistics Canada data, vehicles with large conventional engines make up the lion's share of exports to the EU, and this is consistent both with our understanding of the Canadian vehicle assembly industry, and with the *Ward's Automotive* data reported in *Table 3* above. Finally, the unit values derived from the Statistics Canada data are more consistent and reasonable. For all these reasons, the Statistics Canada data seem to provide a more convincing portrait of Canada's exports to the EU than the European data cited by DFATD. Indeed, it is not clear why Canadian trade officials would rely on European data, rather than using the government's own (Canadian) statistics.

TABLE 5 Statistics Canada Data on Canadian Vehicle Exports to the EU, 2007–12

Harmonized Code	Engine Size		2007	2008	2009	2010	2011	2012	6-Year Total
Conventional Engine									
870321	Under 1 l	Units	6,324	4,043	446	219	219	254	11,505
		Unit Value	$8,286	$7,491	$9,250	$7,447	$11,567	$11,991	$8,172
870322	1-1.5 l	Units	48	95	102	87	74	73	479
		Unit Value	$16,242	$14,280	$13,415	$11,255	$14,008	$12,987	$13,504
870323	1.5-3 l	Units	1,014	1,989	1,008	699	825	559	6,094
		Unit Value	$11,936	$11,708	$14,571	$16,453	$16,169	$19,824	$14,112
870324	Over 3 l	Units	714	956	1,125	860	1,773	2,439	7,867
		Unit Value	$21,830	$23,596	$26,754	$20,543	$26,580	$31,071	$26,543
Diesel Engine									
870331	Under 1.5 l	Units	5	3	5	5	0	9	27
		Unit Value	$28,965	$35,471	$24,020	$21,833	$0	$32,689	$28,693
870332	1.5-2.5 l	Units	4	14	4	6	6	2	36
		Unit Value	$15,375	$33,839	$21,150	$26,311	$21,950	$24,350	$26,614
870333	Over 2.5 l	Units	7	4	9	11	5	8	44
		Unit Value	$44,635	$41,720	$79,031	$92,878	$51,322	$66,799	$68,256
Vehicles Not Elsewhere Specified									
870390	All	Units	16	20	167	39	3	33	278
		Unit Value	$5,824	$10,312	$10,041	$10,134	$22,286	$10,465	$10,013
Total Vehicles									
Units			**8,132**	**7,124**	**2,866**	**1,926**	**2,905**	**3,377**	**26,330**
Unit Value			**$10,020**	**$11,011**	**$18,448**	**$17,374**	**$22,200**	**$27,267**	**$15,299**

Source Statistics Canada, Canadian International Merchandise Trade database (http://www5.statcan.gc.ca/cimt-cicm).

It is clear that the Canadian officials who negotiated the automotive provisions of the CETA do not know what vehicles Canada exports presently to the EU, or how many. It is thus hard to expect that they would be able to meaningfully judge whether the proposed deal will have any positive impact whatsoever on Canadian automotive exports to Europe. As the Canadian parliament moves to consider the specifics of the CETA,[11] it will be essential for the federal government to provide a more complete description of Canada's existing vehicle exports to the EU (quantity, value, and composition), and a detailed analysis of what concrete export opportunities may

be opened up by EU tariff elimination (rather than just assuming that free trade agreements necessarily boost all exports). It is hard for Canadians to judge the likely impacts of the deal, without even understanding our current automotive trade relationships with Europe.

Despite the lack of precise data on Canadian vehicle exports, it is indisputable that existing bilateral trade in finished vehicles is enormously unbalanced, whether measured in units or in value. In units, we know that our imports of finished vehicles from the EU equaled 118,093 units in 2013, equivalent to 7 percent of our domestic market. Canadian exports of finished vehicles going the other way are much smaller. Industry Canada, Statistics Canada, and *Ward's Automotive* data all suggest those exports likely totalled less than 5,000 vehicles in 2012. And by any measure they accounted for well under 0.1% of the much larger European market.[12] In other words, the import market share of European automakers in Canada's market is thus at least 100 times larger than the import share of Canadian-made vehicles in the EU market. This imbalance (and the effective invisibility of Canadian-made vehicles in the European market) is a fundamental structural feature of our existing bilateral trade that will undoubtedly limit the potential benefits to the Canadian industry of tariff reductions and other CETA provisions. But this structural reality, unfortunately, has been glossed over in Canadian promotional materials trumpeting the value of this trade agreement for Canadian automakers — even though the government that negotiated the deal cannot describe what vehicles we sell in Europe today.

Foreign Direct Investment

Another important structural factor impacting on the nature of automotive trade patterns is the distribution of foreign direct investment. Auto assembly is a globalized (or at least continentalized) production system, in which location decisions regarding investments in key facilities powerfully affect the direction and balance of trade flows. Foreign direct investment abroad can be both a substitute and a complement for trade flows.

No European-based automakers have direct manufacturing operations in Canada.[13] Several have established facilities elsewhere in North America (all located in Mexico or in low-wage southern states of the U.S.), and hence about one-third of their total sales in Canada already enter this country tariff-free under the terms of the NAFTA.[14]

TABLE 6 Bilateral FDI Stocks, Transportation Equipment Manufacturing ($ billions)

	Canadian FDI in Europe	European FDI in Canada
2002	$7.9	$1.4
2008	$6.5	$1.7
2012	$3.5	NA

Source Unifor Research from CANSIM Table 376-0052.

Four automakers with assembly facilities in Canada, also operate production operations in the EU. This includes Ford (with 6 assembly plants and 12 powertrain and components facilities in the EU), General Motors (operating 7 assembly plants and 4 powertrain and components facilities in the EU, under its subsidiary Opel), Toyota (operating 9 manufacturing plants in the EU), and Honda (operating 3 assembly plants in the EU). For these companies in particular, it is likely that their ongoing efforts to build market share in Europe will rely primarily on output from those European plants (in order to minimize transportation costs, avoid exchange rate risks, and other factors). Chrysler's alliance with Fiat will also likely soon entail the manufacture of Chrysler-branded vehicles in European plants.

There is considerable two-way foreign direct investment across the Atlantic in the automotive parts sector. Some larger Canadian-based parts firms (such as Magna, Linamar, and Martinrea) operate production facilities in Europe, supplying parts to European-based assembly facilities. By the same token, several European-based parts firms operate facilities in Canada — including companies such as Continental, BASF, Faurecia, Schaeffler, Benteler, and Mahle. Given the importance of logistical optimization and minimizing transportation costs (especially in the context of just-in-time production methods used by most vehicle assemblers), parts facilities tend to locate near to the assembly plants they service. In this regard, tariff reductions and other trade liberalization initiatives will have a limited effect on trade flows in auto parts, except insofar as these trade liberalization measures affect the location of future assembly plant investments.

Table 6 summarizes Statistics Canada data on foreign direct investment between Canada and the EU. The data apply to the entire transportation equipment manufacturing sector (including segments, such as aerospace and railway equipment, not relevant to this discussion); more disaggregated FDI data for the auto industry are not available. Furthermore, the most recent data on European FDI in Canada (after 2008) is suppressed by Statis-

tics Canada for confidentiality reasons. *Table 4* indicates that FDI in Europe by Canadian firms is several times larger than FDI in Canada by European firms, in the broad transportation equipment manufacturing sector. (This includes major investments in Europe by Canadian aerospace and railway equipment producers, particularly Bombardier.) However, the value of Canadian FDI in Europe has diminished in recent years (perhaps reflecting restructuring the wake of the financial crisis and resulting European recession).

Macroeconomic Factors

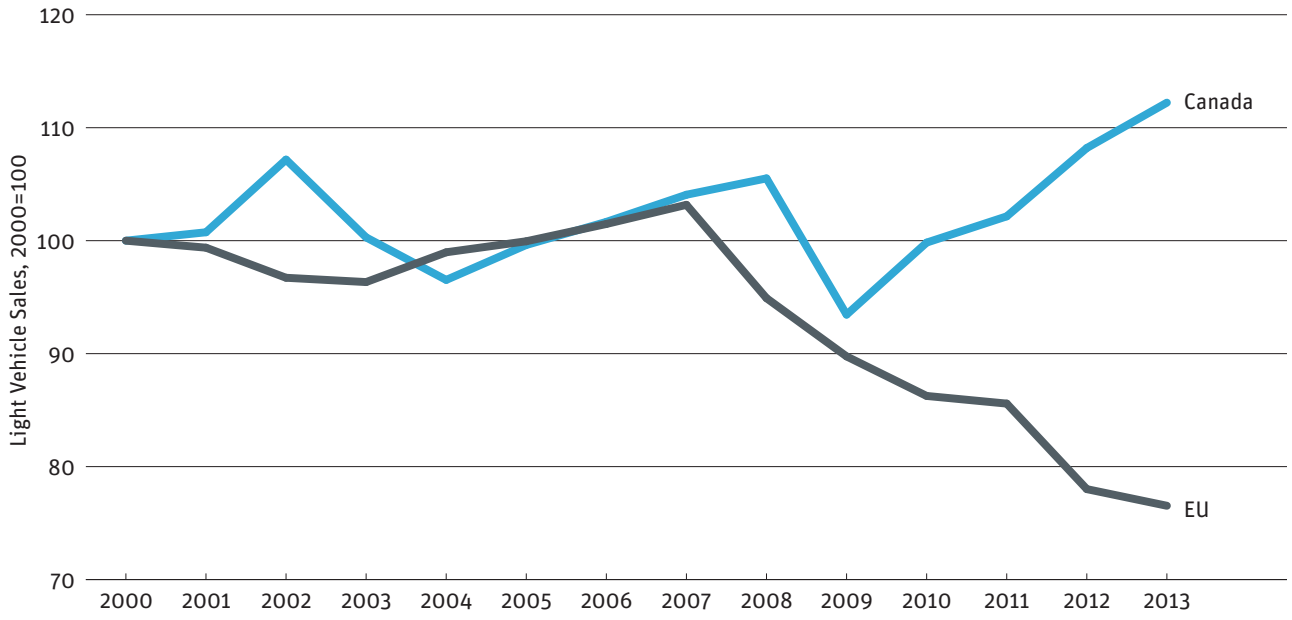
Motor vehicles are a consumer durable, the purchase of which is very sensitive to macroeconomic variables such as employment, consumer income, consumer confidence, and borrowing costs. Divergent macroeconomic trends in Europe and Canada have surely influenced the path of trade relations in automotive products between the two markets. But these issues have been ignored in most official discussions of Canada-EU trade relations.

Figure 3 compares the evolution of new vehicle sales in the EU and Canada since the turn of the century. The figure portrays an index of total light vehicle sales (in units), with 2000 set equal to one hundred. (The total EU vehicle market, of course, is much larger than Canada's: about 8 times more vehicles are sold each year in the EU than in Canada.) The two markets followed similar trends until the financial crisis of 2008 (with the exception of a unique and short-lived spike in Canadian vehicle sales in 2002). After 2008, however, the two markets diverged dramatically. In the wake of bank failures, instability in debt markets, and severe government austerity policies, new vehicle sales in Europe fell sharply with the recession — and have kept falling. Vehicle sales in 2013 were one-quarter lower than in 2000.

In Canada, in contrast, vehicle sales suffered less severely from the 2008–09 downturn, and began recovering strongly right afterward. Vehicle sales are now at record highs (12 percent higher in 2013 than in 2000).

The divergent strength of the vehicle markets in the two jurisdictions has clearly contributed to the unbalanced automotive trade relationship between Canada and the EU, for several reasons. First, a strong sales climate tends to naturally pull in more imports (even if market shares were constant). Second, the economic crisis in Europe has encouraged companies and governments to look to offshore exports as a needed source of demand and economic growth. So European producers have redoubled their efforts to push output into offshore markets. Finally, exchange rate fluctu-

FIGURE 3 Index of Domestic Auto Sales, Canada and EU, 2000–13

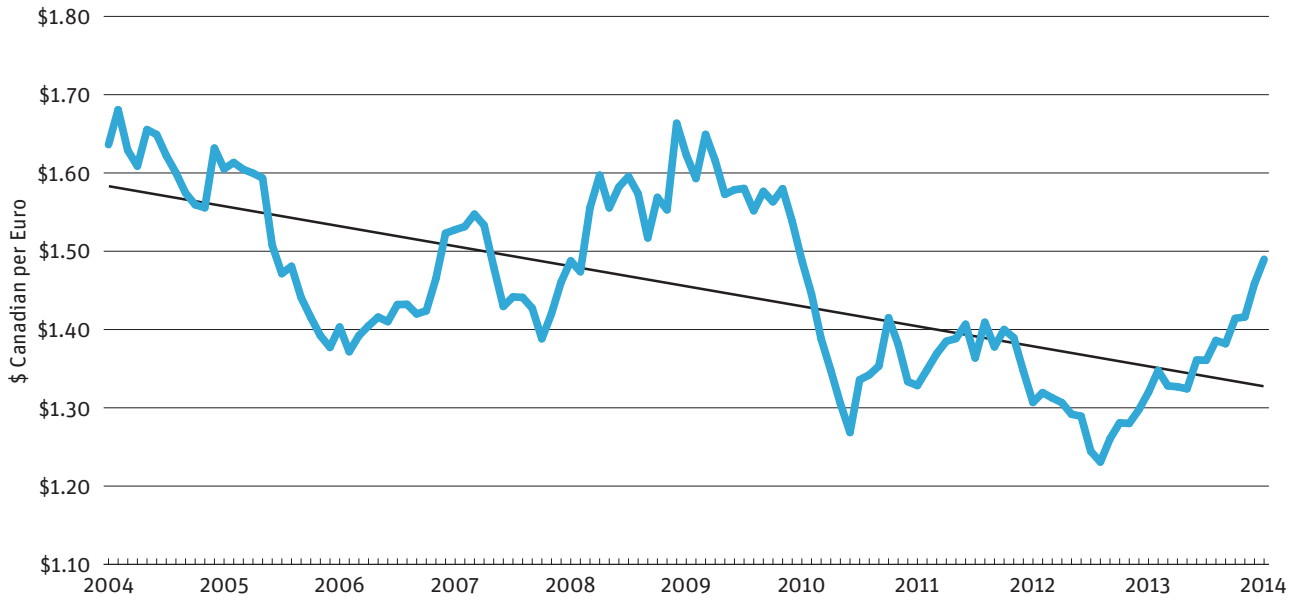


Source Unifor Research from Ward's Automotive data.

ations in the wake of the financial crisis (and the continuing debt problems in Europe) have exacerbated the imbalance.

Figure 4 illustrates the evolution of the bilateral exchange rate between the Euro and the Canadian dollar (measured in Canadian cents per Euro) over the last decade. The Euro has experienced a significant and sustained depreciation against the Canadian dollar. On average in 2013, the Canadian dollar was worth 18 percent more relative to the Euro than in 2004. While the Euro rebounded after record lows reached in 2012, European financial officials have indicated their intention to carefully control the currency's ascent. Efforts to forestall the Euro's appreciation were an important motivation for the European Central Bank's recent decision to reduce interest rates.[15] After nearly a decade of overvaluation relative to its purchasing power parity exchange rate, the Canadian dollar has finally begun to soften again (and has declined by over 10 percent, relative to the Euro, in the last year). The overvaluation of the loonie during the last decade clearly worsened Canada's bilateral trade performance with Europe. Moreover, depending on the evolution of financial issues in Europe, and commodity prices in Canada, that overvaluation could clearly arise again in the future.

FIGURE 4 Euro Exchange Rate ($CAD), 2004–14



Source Statistics Canada CANSIM Table 176-0064.

In fact, fluctuations in the loonie-euro exchange rate in recent years have been many times greater than the average EU tariff on Canadian exports to that continent. (According to the EU-Canada joint economic study, the average EU tariff on Canadian merchandise is 2.2%.)[16] Even if EU tariffs on Canadian-made products were removed completely, the landed prices of Canadian-made products in Europe will still depend far more on exchange rates than on trade policy.

Some automakers have raised concerns about the impact of currency misalignment on trade flows, in the context of continuing trade liberalization initiatives. For example, officials with Ford Motor Co. in the U.S. recently highlighted exchange rate "manipulation" as a key concern in proposed trade talks between the EU and the U.S.[17] Canadian officials, however, have raised no similar concerns or demands in the context of Canada-EU negotiations. In fact, exchange rate issues have been ignored completely in both the negotiations and the underlying economic analysis cited by government officials in support of the proposed deal — even though exchange rates can have a far larger impact on relative competitiveness than tariff reduction.

Reported Automotive Provisions of the CETA

THE CANADIAN AND EU governments announced in October they had reached an "agreement in principle" on a new free trade deal. However, text of the deal has not been released for public inspection and analysis. Indeed, it is reported that many components of the deal are still being negotiated—raising the important question of why a "deal" was announced (with such fanfare) at that particular time.

Despite the lack of official details, on the basis of industry briefings, government summaries, and media reports, a reasonably comprehensive picture of the automotive provisions of the proposed deal has emerged. We understand that these provisions will include:

- Full market access to imports from the other jurisdiction, and strict limitations on trade interventions, imposition of national performance requirements, duty drawbacks, and other trade interventions.
- Mutual elimination of tariffs on automotive products (including both finished vehicles and auto parts) over periods ranging up to seven years.
- Establishment of a domestic content threshold (required to qualify for tariff-free access to the partner market) of 50% for finished vehicles (rising to 55% after seven years).

- A unique "derogation" rule which will allow Canada to export up to 100,000 vehicles per year tariff-free to the EU market with domestic content of only 20% (instead of the normal 50%), measured by net cost. This special provision would expire if and when the U.S. reaches a free trade agreement with the EU, in which case the rule of origin would rise to 60% (combined Canada and U.S. content) for vehicle exports to the EU.
- Limited measures allowing mutual recognition of regulatory standards on vehicles (primarily involving the acceptance in Canada of certain European standards on vehicles imported to Canada, primarily affecting specialized vehicles as opposed to mass market automobiles).

Locking in a Huge Deficit

It may seem obvious, but nevertheless should still be noted, that the most important effect of the CETA on the auto industry will be to lock in the current enormous imbalance in bilateral auto trade. By guaranteeing Canadian market access for EU producers (with no guarantees that Europe will purchase Canadian-made vehicles, nor that European OEMs will produce any of their own vehicles in Canada), and placing strict limits on any future trade interventions aimed at reducing that imbalance, a free trade agreement with Europe would confirm that the current state of affairs is both legitimate and in effect permanent.

Canada's trade policy since the late 1980s has allowed for the emergence of enormous one-way trade imbalances with key auto-producing jurisdictions without protest or mitigation. Only with the U.S. is our automotive trade broadly balanced and reciprocal; with every other auto-producing jurisdiction (including the EU, Mexico, Japan, Korea — and likely China in coming years) auto trade is one-way in nature, whereby Canada is just a market not a trading partner. The failure to ensure a proportional global foothold for Canadian facilities in this crucial, strategic industry has facilitated the descent of Canada's auto industry from leader to laggard. In 1999 the industry enjoyed an aggregate trade surplus of over $15 billion, and Canada ranked as the 4th largest auto assembling nation in the world. Since then, the industry has stumbled in the face of unbalanced international trade relationships (exacerbated by an overvalued currency and the lack of a consistent, effective national auto industry strategy). Our once-impressive surplus has dissolved into an equally large trade deficit, Canada fell right out

of the ranks of the top ten assemblers, and over 50,000 well-paying jobs in auto manufacturing were lost. And yet all that was in the context of a domestic vehicle market that was one of the most vibrant and stable in the world. We have missed the opportunity to link our strong sales with strong investment, production, and employment.

The trade deficit with the EU is only part of that broader economic and policy failure, but it is an important part (our bilateral automotive trade deficit with the EU accounted for close to one third of our overall auto trade deficit in 2013). More importantly, how policy-makers confront the European imbalance will set an important precedent for future trade arrangements with other auto producing jurisdictions — including talks already under way with Japan and Korea, potential initiatives to reform NAFTA and address our massive and growing automotive imbalance with Mexico, and perhaps future negotiations with China. With this proposed CETA, Canada is signalling clearly that the strategic automotive industry (with its crucial impacts on supply chains, trade performance, and productivity) will be treated like any other sector in a free-trade world, with no particular requirements or constraints on the production or investment decisions of global automakers.

Not all countries in the world treat the auto industry in such a *laissez faire* manner, given its strategic economic significance. Jurisdictions such as Brazil, Korea, Japan, China, and Russia have all used pro-active trade policy interventions in recent years, focused on the auto industry, to ensure a continuing strong domestic production base and positive net exports. Europe, too, uses active hands-on policy tools to protect a strong foothold for European OEMs, ranging from minority state ownership to active technology and skilling supports to favourable government procurement strategies. Adopting a different, more interventionist trade policy approach for Canada would be a challenging undertaking in any event. But the CETA would make it all the more difficult for Canadian governments to challenge the current state of affairs (whereby European producers sell 92 times more finished vehicle value in Canada, than Canada sells in the EU) that is both destructive and unacceptable. Accepting this unbalance as somehow normal and acceptable, and locking it in with unconditional market access commitments, constitutes a historic failure of vision and responsibility. We doubt European negotiators would ever accept a trade deal which so entrenched such an inferior trading position in such a strategic, high-value industry.

Incremental Impacts of Tariff Elimination

Canada currently collects a 6.1% tariff on imports of finished vehicles from the EU. Canada collects no tariff on automotive parts (the tariff was eliminated years ago to encourage investments in Canadian auto assembly plants). On a weighted average basis, Europe's automotive sales to Canada (weighted so heavily in finished vehicles) are subject to an average tariff of under 5%.

The EU currently collects a 10% tariff on imports of most finished vehicles from North America. It also collects varying tariffs on various categories of auto parts, ranging from zero to 4.5%. On a weighted average basis, Canada's automotive exports to Europe (concentrated heavily in parts) are subject to an average tariff of under 5%.

Both sides will therefore benefit from a modest increase in competitiveness in each other's market, as a result of mutual tariff elimination. The proportional weighted average tariff reduction is roughly equal for the two sides (under 5%). However, the unbalanced nature of the initial starting positions means that the absolute increases in export flow stimulated by tariff elimination will be considerably larger for Europe than for Canada.

Economic modelers typically simulate the effects of tariff reduction by assuming some degree of elasticity in consumer decisions, and then applying that elasticity along with the size of tariff reduction against a starting trade flow. The fact that the EU's automotive sales to Canada are more than 20 times larger than the flow going in the other direction, means that the resulting growth in Canadian imports from Europe will be several times larger than the stimulus given to Canada's exports to Europe.

This reality is confirmed by various economic simulations of the effects of a CETA. For example, the EU-Canada Joint Study published in 2008 predicted that EU automotive exports to Canada would grow by 631 million euros (at 2007 prices), while Canada's automotive exports to the EU would grow by 255 million euros — resulting in an increase in the bilateral trade deficit of about 15% (or about $600 million).[18] This study was calibrated to baseline data from earlier in the 2000s when Canadian automotive exports to Europe were larger than at present.[19] Hence the true increment to Canadian automotive exports will be smaller, on the basis of current data.

The EU-Canada study used computable general equilibrium modeling techniques which have been criticized for unrealistic assumptions (including full employment, balanced trade, lack of international capital mobility, and others). An alternative sector-by-sector modeling approach, unconstrained by these general equilibrium assumptions, was utilized in a 2010

report from the Canadian Centre for Policy Alternatives.[20] In this model, Canada's automotive exports to the EU grow by only $116 million due to tariff elimination, while the EU's automotive exports to Canada grow by $1.9 billion. In this case, the trade deficit deteriorates by $1.8 billion — three times as much as predicted in the Joint Study.[21]

In any event, regardless of the precise modeling methodology chosen, all analysts agree that Canada's existing bilateral automotive trade deficit with the EU will worsen after CETA. In a context in which labour is unemployed, and firms must compete for scarce markets (as opposed to the general equilibrium assumption that all output is automatically sold and the economy is constrained only by the supply of productive factors and the efficiency of their use), a larger trade deficit inevitably results in a net decline in demand for Canadian-made products.

The immediate impact of a wider trade deficit with the EU on Canadian production and employment will depend on the extent to which growing imports from Europe displace Canadian-made vehicles (as opposed to displacing vehicles from other sources), and the eventual impact of declining net sales on future investment decisions by the automakers which produce in Canada. Several Canadian-made vehicles compete directly with European imports in higher-end and luxury segments: including Cadillacs produced in Oshawa, Fords and Lincolns produced in Oakville, the Chrysler 300 sedan produced in Brampton, and Lexus and Acura CUVs produced in Cambridge and Alliston. The CETA's removal of tariffs will provide European-made competitors to these made-in-Canada products with a 6.1% price advantage in future sales competition here in Canada.

Impact on Investment Decisions

The more important potential impact of the greater penetration of European imports into Canada's market after a CETA would be its effect on future investment and model allocation decisions by the automakers currently producing in Canada. Automakers seeing a decline in their own branded sales in Canada as a result of the favourable treatment given to European-based producers (even if some of the displaced sales were produced outside of Canada) may take this into account in future production and investment decisions in Canada. Those decisions could damage future Canadian production more significantly than the incremental erosion of Canadian sales

of certain Canadian-made vehicles resulting from the improved price competitiveness here of vehicles imported from the EU.

By the same token, one potential upside to the Canadian industry from tariff-free access to the EU market could be a positive impact on model allocation decisions to Canadian plants by automakers considering incremental exports of North American-made vehicles there. Until such time as the U.S. also enters a trade pact with Europe, the fact that Canadian-assembled vehicles could be exported to the EU tariff-free might serve as an incremental reason to allocate certain models with greater offshore export potential to Canadian plants. This upside should not be overestimated, however, for several reasons. First, with rare exceptions automakers use their North American plants overwhelmingly to service North American markets, and are not likely to invest in the transportation, distribution or sales efforts that would be necessary to seriously market a North American-made vehicle into Europe. Second, Mexican-made vehicles also have tariff-free access to European markets, on top of additional cost advantages that have attracted so much automotive investment there in recent years. Finally, by the time the EU tariffs have been removed (some years after a CETA actually comes into effect), the U.S. may well have reached a parallel agreement with the EU, negating any Canadian advantage.

The prospect of Canada enticing a direct investment here from one of the major European automakers seems remote, in the absence of deliberate pro-active efforts to motivate such an investment as a condition of unrestricted market access to Canadian consumers. The German OEMs have established major production facilities in Mexico and the low-wage states of the U.S. south. And the continued overvaluation of the Canadian currency undermines efforts to attract direct investment here. Canada's own past experience (first under the former Auto Pact, then when we used additional trade policy levers to attract Canadian investments from Toyota, Honda, and Suzuki), indicates that encouraging a global firm to establish a production footprint here requires more than just an open market, competitive taxes, and quality infrastructure. It requires an active effort from policy, wielding both "carrots" and "sticks," to incent and compel OEM investment here. Yet this is precisely the sort of hands-on policy-making which free trade agreements, exemplified by the CETA, generally restrict or prohibit. In this case, the prospects of European production investments in Canada (despite total sales by European-branded automakers, from all import sources, that are now comparable to the output of a typical assembly plant) is made even more remote by the unconditional market access provisions of the CETA.

Rules of Origin Derogation

A unique challenge was immediately encountered in the course of negotiating bilateral free trade in automotive products between Canada (a single country) and the EU (an integrated continental economy). To qualify for tariff-free access under a free trade arrangement, products must typically meet a rules-of-origin domestic content threshold. This ensures that the product being traded possesses enough content produced within the free trade partner jurisdiction to fairly qualify for this preferential access; rules of origin are intended to prevent trans-shipping and other indirect mechanisms of exploiting a preferential trade arrangement.

The problem in the case of motor vehicles is that it is inherently easier for a larger, integrated jurisdiction (such as Europe) to meet any given domestic content threshold, by virtue of the larger and more diverse economic area encompassed within its borders. Remember the EU encompasses a much larger population than Canada, and a much wider range of economic characteristics within its integrated perimeter — ranging from high-wage, high-tech facilities in countries like Germany, to lower-wage operations in new member states such as Poland, Romania, and the Czech Republic. For a single, smaller economy like Canada, on the other hand, meeting the same threshold would be more challenging simply because it does not have internal access to the same variety of suppliers and inputs. In the case of a motor vehicle, even one assembled in Canada typically possesses a large amount of imported content (embodied in powertrains, other components, engineering and design services, capital services, and other inputs).

The CETA agreement in principle would define a domestic content threshold for motor vehicles of 50%, meaning that at least half the total value-added embodied in the vehicle must be produced within the respective CETA jurisdiction (either the EU or Canada) to qualify for tariff-free access to the other. This threshold would rise to 55% after seven years. If this rule were applied mechanistically to both sides, the likely reality is that *no* Canadian-assembled vehicles would qualify for tariff-free export to the EU — since no Canadian-assembled vehicle possesses 50% Canadian value-added. In this case, the CETA's automotive provisions would be *completely* one-sided: offering a tariff-free boost to the already-large inflow of European-made vehicles coming in to Canada, while offering no stimulus at all to the tiny flow of Canadian-made vehicles that goes in the other direction. In this case, the CETA's auto provisions would be all downside, with no upside (not even the

very small upside resulting from tariff elimination on Canada's tiny flow of automotive exports to Europe) at all for Canada's auto producers.

To attempt to rectify this situation, the EU and Canadian negotiators settled on a derogation system, whereby a certain number of Canadian-assembled vehicles would qualify for tariff-free access to the EU at a lower threshold of Canadian content (20% when measured by net cost). The flow of Canadian exports entering Europe under this provision would be capped at 100,000 vehicles per year. In the event that the U.S. also enters a free trade agreement with the EU, this provision would disappear — to be replaced by an integrated content threshold requiring that 60% of value-added in a qualifying product be produced within the *combined* Canada-U.S. production area.

This derogation provision means that nominally, at least, the tariff reductions provided for under a CETA would apply to both sides — even though Canadian exports would not otherwise qualify for the preferential treatment as a result of the inherent asymmetry in applying a given rule of origin to a single country versus an entire continent. But this provision should not be interpreted as an "advantage" for Canada, as some commentators have concluded. In reality, it prevents a situation whereby the CETA tariff provisions would offer absolutely *no* benefit to the Canadian auto industry (by virtue of the inability of our exports to meet the same content threshold). Even *with* this provision, however, the tariff reductions under the CETA will stimulate a far greater increase in new imports from the EU, than Canadian exports to the EU, for the structural reasons discussed above.

The 100,000 derogation ceiling has been widely (and perhaps deliberately) misinterpreted by several commentators. Government of Canada promotional materials suggest that the rule will allow for a 12.5-fold increase in Canadian vehicle exports to the EU, as if they were somehow restrained at the current much-lower level by an explicit barrier of some sort.[22] There is no quantitative limit on Canadian vehicle exports to the EU at present. And there is no reason to believe that Canadian vehicle exports will increase so dramatically, up to the 100,000 vehicle ceiling, even with the removal of the EU's tariff. As explained above, the lack of market foothold, lack of brand awareness, and general lack of interest by Canadian-based automakers in exporting from Canada to Europe all imply that the increase in Canadian vehicle exports to the EU will be marginal, even if the EU tariff is removed — and even if a certain number of Canadian-made vehicles can qualify for tariff-free status with a lower level of Canadian content. Other federal and provincial commentators have gone further, implying that the

measure is equivalent to increasing Europe's "quota" on vehicle imports from Canada.[23] There is no such quota.

In that regard, the ceiling on the derogation provision could have been set at 1 million units per year, but that hardly means that Canada would therefore soon be exporting "up to 1 million units per year" to the EU market. EU briefing materials distributed to European negotiators during the CETA talks acknowledged the largely symbolic nature of the derogation provision, indicating that Canada's request for it "is of political rather than economic importance so as to be able to present the car deal as balanced."[24]

Conclusions and Recommendations

DESPITE ITS RECENT challenges, Canada's automotive manufacturing sector still plays a vital and disproportionate role in Canada's national economy. The sector is Canada's second-largest export industry (after petroleum products), and largest manufacturing industry. Its superior productivity and income generating potential, and strong spillover linkages, mean that hundreds of thousands of Canadians depend — directly or indirectly — on its success. A major factor in the industry's recent problems has been the very lopsided nature of automotive trade relationships between Canada and every other auto-producing jurisdiction with the exception of the U.S. And our virtually one-way auto trade relationship with the EU is a major part of this trade problem.

The provisions of the CETA (locking in market access for producers on either side, gradually eliminating tariffs, and including a unique content derogation provision to recognize Canada's inability to meet the normal rule of origin in this sector) will lock in the current trade imbalance with the EU, and make it incrementally worse. The boost in automotive exports resulting from bilateral tariff elimination will be much larger in absolute terms for the EU side than the Canadian side, for several reasons:

- Europe's much larger initial market share here (100 times larger than Canada's market share in Europe);

- the well-developed marketing infrastructure of European producers in Canada;
- the lack of manufacturing investment in Canada by European automakers;
- the lack of spontaneous mass market appeal within Europe for North American vehicles;
- the depressed macroeconomic conditions that will prevail in Europe for several years to come;
- and the distorting impact of a depreciated Euro (and a strong Canadian dollar) on relative competitiveness.

The existing $5.3 billion trade deficit with Europe will thus become incrementally larger after a CETA; we expect that bilateral deficit will exceed $7 billion (other factors remaining constant) within a decade.[25] The decline in net demand for Canadian-made automotive products arising from this widening bilateral deficit will negatively affect Canadian production, investment, and employment opportunities, both directly (as Canadian-made vehicles are directly displaced by cheaper competitors from the EU) and indirectly (as the general downturn in Canadian demand for their products, even those not made in Canada, undermines automakers' commitment to investments and model allocations in Canadian facilities).

The following recommendations could potentially help to make the proposed CETA less harmful for Canada's auto industry:

- The Canadian government should prepare a detailed statistical inventory on Canadian-made vehicles currently exported to Europe. It should survey automakers producing in Canada regarding the opportunities for market growth in Europe for their products, in the event of the elimination of EU tariffs on automotive products. This will fill a statistical void in our collective knowledge of current bilateral automotive trade, and provide context by which the potential benefit of a CETA for Canadian auto exports to the EU could be more realistically evaluated. It is impossible to believe the government's claim that the CETA will provide a major boost to Canada's auto industry, when the government doesn't even know what vehicles, or how many, Canada presently sells in Europe.

- The Canadian government should provide specific supports for automakers producing in Canada, to assist them in developing offshore market opportunities in general, and sales to the EU in particular. These could include the development of export-oriented transportation infrastructure, subsidies for the development of export-oriented features (including right-hand drive vehicles), and support for overseas marketing.

- As a condition of tariff elimination on vehicle exports to Canada, the Canadian government should require European automakers to invest in Canadian production opportunities (either independently, or through joint venture arrangements with other firms), in vehicle assembly, parts manufacturing, or other production offsets. Volkswagen's former contract manufacturing arrangement with Chrysler in Windsor is an example of how this type of arrangement can be feasibly attained even at relatively smaller scale of production.

- A condition of the implementation of a CETA should be a mutual understanding between the two parties regarding an appropriate valuation for their respective currencies, and a prohibition of policy efforts aimed at attaining a competitive advantage through deviation of the exchange rate from its underlying fair value. In the event that one party's currency deviates substantially and consistently from that underlying fair value (especially where that outcome reflects, in whole or in part, deliberate policy interventions), the other party must have recourse to offsetting measures to avoid a resulting distortion in trade flows.

Measures such as these would provide stakeholders in Canada's auto industry[26] with more confidence that a free trade deal with Europe might result in at least some concrete benefits to the Canadian side, not just an even-larger inflow of European-made vehicles.

Notes

1 Two-way flows in NAICS 3362 products (truck and bus bodies and trailers) are small, representing the difficulty in transporting these bulky products across the Atlantic.

2 At peak, GM imported 2000 Buick Regals from Europe in 2010.

3 Labour costs in most auto plants in Germany, France, and Belgium are higher than in Canada.

4 Chrysler has been relatively ambitious in developing offshore market outlets for its production, in part because Chrysler (unlike GM and Ford) does not have many overseas assembly facilities to service offshore markets. The *Ward's* export data has included Chrysler sales in previous years, but not after 2008.

5 This problem applies to the following multi-sourced vehicles listed in Table 3: Honda Civic, Honda CR-V, and Toyota Corolla. Offshore export volumes of these vehicles are not large, hence the potential error introduced by this lack of disaggregation will not be severe.

6 Mike Colias, "A Missed Opportunity for GM, or a Fresh Start?", *Automotive News*, December 9, 2013.

7 Department of Foreign Affairs, Trade and Development, "Technical Summary of Final Negotiated Outcomes," p.6. http://www.actionplan.gc.ca/sites/default/files/pdfs/ceta-technicalsummary.pdf

8 The greatest fluctuations in apparent unit values are for category 870390, where apparent unit values vary wildly from a low of $4,000 per vehicle to a high of over $320,000 per vehicle.

9 Another way of making the same point is to compare the apparent export of over 10,000 Canadian-made vehicles to the EU in 2012 reported in Table 4, with the aggregate value reported by Industry Canada for Canadian-made vehicle exports to Europe in the same year (indicated as $75.5 million in Table 1). This implies an average unit value of about $7,500 — far too low to reflect the real output of Canada's auto industry (and about one-fifth the average $36,000 unit value of Canadian imports of EU-made vehicles that was noted above). Note that the Eurostat data cited by DFATD indicates a total value of imports of Canadian-assembled vehicles equal to $233 million — three times the total value reported by Industry Canada.

10 It is often the case that trade data differ from the exporting source to the importing source due to multiple issues (including differing methodologies, measurement or categorization error,

transshipments of trade through third countries, and other factors). At a minimum we should be aware of those differences and try to account for them, and provide some rationale as to why one source is preferred over another.

11 Of course, that cannot occur until a final agreement with the EU has in fact been reached.

12 Even if Canada did export 10,000 vehicles to the EU in 2012 as implied by Table 4 (and which seems very unlikely), that represents 0.07% of EU new vehicle sales that year.

13 In recent years Volkswagen produced a minivan in Canada, the Routan, under a contract manufacturing arrangement with Chrysler that has now ended.

14 North American-made vehicles sold in Canada by the European automakers are not included in the import sales summarized in Table 2 above.

15 See for example http://www.telegraph.co.uk/finance/economics/10433098/ECB-surprises-markets-with-interest-rate-cuts.html. ECB officials are targeting a lower exchange rate both to maintain export competitiveness, and to boost domestic inflation.

16 European Commission and Government of Canada (2008). *Assessing the Costs and Benefits of a Closer EU-Canada Economic Partnership* (Ottawa: Department of Foreign Affairs and International Trade), p.33.

17 Carmen Ponn, "Ford Wants Trade Deal to Bar Currency Manipulation," *Ward's Automotive*, Nov. 7, 2013.

18 European Commission and Government of Canada (2008). *Assessing the Costs and Benefits of a Closer EU-Canada Economic Partnership* (Ottawa: Department of Foreign Affairs and International Trade), p.57.

19 In fact, curiously the baseline data set used by this study assumes Canadian auto exports to the EU of 885 million Euros (or $1.2 billion) — a scale of automotive exports which is clearly erroneous and has never been attained in practice.

20 *Out of Equilibrium: The Impact of EU-Canada Free Trade on the Real Economy*, by Jim Stanford (Ottawa: Canadian Centre for Policy Alternatives), 2010.

21 Other simulations reported in this study indicate potential for even larger deficits for Canada, once the impact of exchange rate misalignment is considered.

22 Department of Foreign Affairs and International Trade, "How CETA Will Benefit Canada's Key Economic Sectors," p.5. http://www.actionplan.gc.ca/sites/default/files/pdfs/final-sectors-eng.pdf

23 See, for example, comments by MP Colin Carrie which claim the deal will "allow up to 100,000 passenger vehicles to be exported to Europe, a twelve-and-a-half-fold increase from current average exports," in a statement at http://www.colincarriemp.ca/news_releases/News%20release%20-%20Carrie%20applauds%20CETA%20Announcement,%2018%20Oct%202013.pdf. In reality, there is no limit — neither now, nor after CETA — on how many Canadian-made vehicles can be exported to the EU, so long as European consumers are willing to purchase them. Similarly, Ontario Industry Minister Eric Hoskins was quoted in media coverage that Ontario vehicle exports to the EU are "expected" to increase to 100,000 units; see "Wynne hails 'very good deal,' but warns Ontario has concerns," by Robert Benzie, *Toronto Star*, October 18, 2013.

24 "EU Canada Comprehensive Economic and Trade Agreement — update on state of play in key negotiating areas," European Commission Directorate-General for Trade, June 5, 2013, p.1.

25 This estimate is consistent with the modeling results presented in Stanford (2010), *op cit*.

26 Of course, the proposed CETA agreement in principle touches on a wide range of other sectors and economy-wide issues, that must be considered and evaluated before any judgment is made on the benefits and costs of the overall agreement. The discussion in this paper focuses only on the proposed CETA's likely impacts on the Canadian auto industry.

CCPA
CANADIAN CENTRE
for POLICY ALTERNATIVES
CENTRE CANADIEN
de POLITIQUES ALTERNATIVES