Canada-United States Law Journal

Volume 23 | Issue Article 51

January 1997

Restructuring under NAFTA: What Are the Considerations and How Do We Implement Them–Has NAFTA Changed Patterns of Manufacturing Location, Distribution, and Market Penetration--A U.S. Perspective

William P. Keely

RESTRUCTURING UNDER NAFTA: WHAT ARE THE CONSIDERATIONS AND HOW DO WE IMPLEMENT THEM? HAS NAFTA CHANGED PATTERNS OF MANUFACTURING LOCATION, DISTRIBUTION, AND MARKET PENETRATION?-A U.S. PERSPECTIVE

*William P. Kelly**

As I travel around the world, I have often noticed a fondness with which politicians praise events, ideas, and causes that bring people together, and it seems to me that few things have really achieved that so much as NAFTA. If you think about it, Florida tomato farmers and industrial trade union leaders would never have known what they share in common had it not been for NAFTA. Political arch-conservatives in both Canada and the United States, populist, environmental groups, and particularly here in the United States, the left wing of the Democratic party and the right wing of the Republican party, Ralph Nader and Pat Buchanan, libertarians and socialists, Ross Perot, all of them seem united at least in the common view that NAFTA is a very bad idea.

I intend to discuss briefly the reasons for Ford Motor Company's original support of NAFTA; how Ford has adjusted to the new business climate that NAFTA has created for us; and some possible directions for the future that go beyond NAFTA. Let me begin with a couple of observations.

First, in the auto industry, NAFTA primarily means the integration of Mexico into the North American auto market. Canada and the United States already achieved this in 1965. Today, Canada and the United States are virtually seamless. Second, NAFTA is only one-third of the way through its implementation. So we can take only a snapshot, not a definitive portrait, at least in the auto industry of NAFTA's effects. To make a clearer assessment, it really is going to have to wait at least seven years, and, frankly, I think probably twice that amount of time. It is going to take a while before the industry fully adjusts to all of this. But there are a lot of things happening today, things that happened

* William P. Kelly is the Director of International Government Affairs for the Ford Motor Company, Dearborn, Michigan.

almost immediately with NAFTA, and we will discuss some of them here.

I have to say Henry asked me earlier this evening to put things into a global perspective, and I am going to mention a few things about the global industry just to help you understand where NAFTA fits.

Last year, in 1996, all of the world's automotive producers made or sold just about fifty million vehicles. We could build last year about seventy-two million vehicles. There is an enormous overcapacity in my industry, which is increasing. It is growing; it is not diminishing. Last year, the Mexican internal market rose 331,000 units. They produced more because of exports. To give some order of magnitude here, the U.S. total market, including imports, typically ranges between fifteen and fifteen-and-a-half and, in a really good year, about sixteen million vehicles.

We expect over the next decade that this fifty million I mentioned for the world is going to grow to something in the order of sixty-two, maybe sixty-three million units, and most of that growth is going to occur outside of the developed world. It is going to occur in Asia and Latin America, a little bit in Eastern Europe, and a relatively small increment in percentage terms in North America and in Western Europe. So that is where the industry is going, and this is why you have read in the past about everyone being concerned about doing business in Asia. Most of that development, in this case, is occurring in that market.

Let me talk now about Ford's historical support for NAFTA. When the idea first arose, Ford was interested in it, but we were really much less enthusiastic than the media would lead you to believe. In fact, there is a great term in England called "euroskeptics." These are people who are not exactly totally enamored of the idea of full integration of the European Union on the part of Britain. Ford was a NAFTA-skeptic perhaps more so than our two other major American-based companies.

We had operated in Mexico a very long time, as had the others, since about the 1920s or 1930s. We thought we understood the market. Like Chrysler and General Motors, we had made significant investments in Mexico under what I might call "developing country rules," rules that would not be our first choice, but rules that were not uncommon and rules that at least were understood, were acceptable, and that provided a certain degree of familiarity. I will not say stability, but familiarity.

Our initial concern about NAFTA was that it might make Mexico an export platform to the U.S. market for some Asian or European competitors who are already here. Mexico is not a low-cost producer, despite its low wage rates. The only way this could work is with high-volume export production using Mexican assembly, and Asian or perhaps European components. Incremental vehicle production then could also be sold in the Mexican market.

Ford thought this issue could be addressed in negotiations, but we were uncertain about the governmental resolve to do so. Our Mexican investments had been made under old rules that diminished the international competitiveness of our Mexican-built products. Our market share that was then relatively strong in Mexico perhaps might be jeopardized by a free-trade area, and our substantial in-capital investments could be put at risk as well.

The dual effects of this worst-case scenario were reduced market share in the United States, Mexico, and possibly Canada; and reduced employment and assembly and component manufacture in all three markets. These effects were potentially very difficult and very troubling to contemplate. Yet we considered it an effective rule of origin with rules that took care of this and ensured that NAFTA benefits went to companies which truly had a firm manufacturing commitment to the region that would be helpful and acceptable to us. It might also phase out the trade-and-investment-distorting Mexican auto decree and open Mexico for Ford's financial services and operations. These were all major pluses for us.

On balance, we decided that we had two choices: to support NAFTA and work closely with governments on crafting an agreement, or to try to continue with the status quo, which, inevitably, is destined to change. These were our choices, and we decided to support NAFTA, to lobby for the strongest possible and most effective free trade agreement achievable. This was not protectionism; it was realism.

In order to fully understand the situation and Ford's decision-making we need to look at what existed in the auto industry prior to NAFTA. Understanding the auto decree will help.

Since 1925, Mexico governed the Mexican automotive industry through a series of decrees. Periodically revised decrees affected what we built, what we sold, and where we sold it. The seventh decree was issued in 1989, and it was that decree that was in effect at the time of the negotiations. Compared with prior decrees, it was fairly progressive. It was less erroneous, but it still imposed high vehicle import tariffs, required complicated trade balancing rules, mandated domestic content regulations, and it still maintained ownership restrictions on auto parts plants that served the Mexican market. Ford, Chrysler, and General Motors have been living under these rules for some time or rules similar to these.

Like its predecessor, the decree forced automotive investment into Mexico, and, in effect, it also forced companies to export from Mexico to other markets. It will not surprise you that the size, proximity, and favorable trade rules existing on their northern border, the United States, made most of those exports come northbound, including Ford's.

A lot of people have overlooked in the NAFTA debate that, before NAFTA, a quasi-free trade agreement already existed with Mexico that was northbound only. Mexican products entered duty-free under GSP rules or they paid low U.S. and Canadian tariffs. Southbound U.S. and Canadian products faced high Mexican tariffs and an array of regulatory and policy barriers to trade.

The auto decree was an excellent example of restrictive trade and investment-distorting regulations, and Mexico was very good at it. In fairness, Mexico also was far from alone in maintaining these kinds of policies. They were, in their time, common practice in much of the developing world, and even after the WTO, they are still common practice.

I should refer those of you who might be interested to the case of Indonesia, which just set up a national car program that caused us to bail out of investment. This national car program picked a Korean company and said the products made by this Korean company would henceforth be treated as Indonesian products, and these would be granted preferential treatment in the Indonesian market. It was a clear violation, if ever we have seen one, of all the WTO commitments that Indonesia has agreed to. But this particular company also happens to be headed by one of the sons of the president of Indonesia, so there is a connection.

NAFTA, despite all of the rhetoric over the last couple of years, does not encourage relocation of production facilities to lower-wage Mexico. It also does not encourage the substitution of U.S. or Canadian goods by Mexican ones. Companies interested in moving production to Mexico or in buying Mexican products were free to do so before NAFTA and they are totally free to do so today. What they were not so free to do before NAFTA was to export U.S. or Canadian-made goods to Mexico.

We could talk about the effect of NAFTA in Mexico, and let me just boil it down to five key points. There are many more. Some of them are just too detailed for consideration in a meeting like this. But let us just look at the five main ones.

First, the foreign exchange requirements under the old rules are being phased out. The automotive decree absolutely required vehicle manufacturers to counterbalance their imports in a 2.5 to 1 ratio. It is very complicated. Basically think of it this way. To get authorization to import a $10,000 vehicle, usually a car, we needed to have $25,000 in our foreign exchange account. By 1994, this ratio was phasing down. It was scheduled to decline to 1.75 to 1, in other words, \$1.75 to \$1.00. NAFTA reduced it further and, more importantly, put trade balancing in a phase-out schedule. That is very important to us and very important to trade in the region.

Second, Mexican car and light truck tariffs were cut by half from twenty percent to ten percent and they are being phased out as well. The phase-out period for cars spans over ten years, and over a five-year period for light trucks.

Third, NAFTA's local content rules are being eliminated. That is another major trade-stimulating provision. Before NAFTA, Mexico required as much as thirty-six percent of the content of vehicles produced for sale in Mexico to be sourced to Mexican-owned companies instead of foreign companies. This requirement, as well, is being phased out over ten years. And NAFTA replaced the Mexican truck decree, in effect with larger trucks, similar to the auto decree but with a special set of regulations.

Fourth, NAFTA established a sixty-two-and-a-half percent standard of preference. The standard of preference is essentially what you have to achieve, and the rule of origin is the rule that they use to say that you have achieved it. But, in any case, the sixty-two-and-a-half percent standard of preference for cars, light trucks, auto engines, and transmissions and the sixty percent standard for other kinds of trucks and special-purpose vehicles, that means that when this full implementation has been achieved, sixty-two-and-a-half percent of the vehicle must be attributable to Mexico, the United States, or Canada. That is if you want to receive the benefits of free trade.

The Mexican market, which is relatively small, and the Canadian market, which is larger, but still relatively small compared to the United States, is less important in terms of access to this market than the fifteen-and-a-half million that we represent here in the United States, and the U.S. tariff is only two-and-a-half percent. So many companies have already found that it does not matter to them. They can jump over this kind of content rule, if they wish, to enter the U.S. market, and so Mexico is not important to them.

Finally, NAFTA opened the Mexican financial services market to U.S. and Canadian firms, which is an extremely important thing for the auto industry. The auto industry's financial services are a major part of our business for financing not only our customers, but also our dealers, and this puts U.S. and Canadian firms on an equal basis with Mexican firms. That is a very important and profitable part.

Today, three-and-a-half or three-and-a-quarter years after NAFTA began showing preliminary results, these changes are positive. The total trade is up forty-five percent or so. You may have heard better figures than I have during the course of this conference. How has Ford responded to all of this? It is a different market for us. The decree has gone away, and a lot of free trade policies are in the process of implementation. What does it mean to Ford?

First, NAFTA enhances investment in production efficiency. So our immediate response to liberalize the Mexican environment is to start to treat North America as a single entity. We have been doing it with the United States and with Canada; now we added Mexico to it. It was easy, and it was logical. We have not treated NAFTA as a separate, unique, unusual organization or opportunity. And that is our business, and that is the automotive business. It may not be true for others. We have no vice-president at Ford for NAFTA, nor do we have a NAFTA office. We have no director of NAFTA affairs. We have, instead, accepted market integration immediately, and we have treated Mexico as we do Canada and the United States. To me, that is the purpose of NAFTA; that is the purpose of market integration, and in our segment of the business, it becomes easy to do.

Liberalized trade rules enabled Ford to increase U.S./Canadian exports to Mexico and in the process give Mexican consumers thirteen Ford vehicle nameplates compared with the nine that we offered prior to NAFTA. Overall, since NAFTA began, we have increased our market share by seven percentage points, but not all of that is attributable to NAFTA. I have to caution you about that, but, nevertheless, it is a fact that we have increased our market share. We moved low-volume production from Mexico back to, in this case Ohio and Ontario. We freed up Mexican assembly capacity to complement U.S. production and Canadian production.

In 1993, the year before NAFTA began, Ford Mexico imported only 1,700 vehicles. They were from the United States and Canada. In fact, the entire market in Mexico in 1993 was only a little more than one percent imported vehicles. In 1994, the very first year of NAFTA, Ford Mexico imported more than 30,000 vehicles. In 1995, of course, after the peso devaluation and all bets were off in Mexico, everything fell. The automotive market declined by more than two-thirds, and, of course, our imports of vehicles declined as well, but it never got back down to the 1993 level of 1,700. We also returned low-volume production to the United States and Canada.

One of the inefficiencies of the auto decree was that it required uneconomic Mexican assembly of vehicles with low sales volume in Mexico. Three such vehicles, for Ford at least, the Mercury Grand Marquis, the Ford Thunderbird, and the Mercury Cougar were at that time assembled in Ford's Cuautitlan plant near Mexico City. So we immediately moved those vehicles back to Mexico through Ohio and Ontario where the Mexican demand could be treated as a small increment of production. We gained an enormous efficiency by doing that. Then we had a capacity at Cuautitlan. Parenthetically, the entire Mexican industry of 331,000 for domestic consumption has a capacity of 1.6 million units. That is very, very big. Ford's capacity is more like 350,000 in Mexico, but the total industry is much larger.

We planned prior to NAFTA to build a Ford Contour and a Mercury Mystique, which are sort of just above the Escort level and are slightly larger than the smallest car we produce in North America. We planned to build those in Missouri and we planned only one facility. We were not sure about market demand, and we accepted that if demand exceeded capacity, we were going to miss some of the market. We were not going to incur all the additional costs and the high overhead of carrying a plant that was built for peaks when we were just going to average out the peaks and valleys and work that way.

NAFTA changed the equation and permitted us to move low-volume production at Cuautitlan. We were able to take that plant, retool it, and build some Contours and Mystiques there, which is what we are doing today. We can now sell those vehicles not only in the Mexican market, which we were not planning to do before because of the auto decree, which prohibited it, but we can also supplement our Missouri production in the United States and Canada. If the market goes up, we have extra production to meet it. If the market goes down, we are not so adversely affected because now we have added Mexico to the equation.

I have to say that most of the products and components, that we produce in Mexico come from the United States and Canada. Our component and parts influence has grown rapidly since 1994, and today Ford vehicles sold in Mexico have roughly about an eighty percent U.S./Canadian content. This is also true with the vehicles that are assembled in Mexico and exported to the United States and Canada. On average, the U.S./Canadian content of a Ford vehicle assembled in Mexico exceeds by a fair margin the U.S./Canadian content of a Japanese vehicle assembled in the United States. And those people who would often say that it does not matter probably do not understand the facts of it. It is true that U.S. companies bring in products from all over the world, but it is also true that the high North American content in U.S. products is not matched at all by any other producer.

In the United States, there is a corporate average fuel economy rule that says that you are counted in what they call the domestic fleet if you are seventy-five percent or more U.S./Canadian content, and the

Japanese producers in the United States do not come close to that. They are still counted as part of the import fleet because they still use imported products from outside North America to assemble their vehicles. I am not being overly critical of that. It is just a fact.

NAFTA is working for Ford. It is doing so by expanding trade among the three countries and without loss of jobs in any one of them. Ford employment in all three markets has either held steady or increased a little bit in the last three years. If I take the figures from 1993 and take the figures from 1996, in Canada, the United States, and Mexico individually or in the aggregate, I have defined a larger figure, or at least a stable figure. There has been no detrimental job effect at Ford.

The United States and Canada today are an integrated, but not yet fully implemented free trade automotive market. That goal is going to come after the year 2004. By then, with full economic recovery, the Mexican market may approach Canada's in size. Already, Canadian-built vehicles are sold in the United States and Mexico. From the United States, Ford F-Series trucks, Tauruses, and Mercury Sables are sold in Canada and Mexico as well. Mexican-built Contours and Mystiques are sold in the United States and Canada. Many of the parts in those vehicles come from both markets and some come from all three.

NAFTA is not perfect, and I would not try to sell you on that. But it does not appear to me to be the looming threat to U.S. or Canadian sovereignty and economic well-being that some critics profess to see. Clearly, more needs to be done. Tariff reduction should be accelerated, and we are working on that. Customs administration needs to be streamlined. We have eight times as many people at Ford working on customs administration in Mexico as we do in Canada. There is no reason for that. We need to streamline those things. Transportation needs to be addressed. There are a lot of transport problems, some of which affect us and some of which do not, but affect the industry generally.

Beyond NAFTA, serious work is necessary to integrate the automotive markets throughout the Western Hemisphere. In May, trade ministers are going to meet in Belo Horzonte, Brazil to discuss the next steps towards this goal. And with a regional free trade agreement on the horizon, it may not be immediately possible, but perhaps an auto FTA would be. Inefficient higher costs to protect industries need not continue to be so.

Brazil's auto production is 1.7 to 1.8 million vehicles, almost the size of Italy or the U.K. in terms of production, and most of it for the domestic Brazilian market is higher costs than world levels. It is more protected than world averages. There are thirty-five, even seventy percent duties. An integrated market, perhaps similar to what the United

States and Canada did in 1965 might offer major benefits to the automotive industry, to its employees, and to its customers. And already MERCOSUR and the European Union have been working out some form of a FTA. Similar talks are underway between the E.U. and Mexico. Mexico and MERCOSUR negotiations are on again, off again, with not a lot of enthusiasm. But, they might be a useful beginning.

Finally, it is obvious to all of us that political, labor, and environmental concerns still exist in all three economies. They need to be addressed openly and with the seriousness of intent by all parties that they deserve. You can certainly count on Ford to be part of that debate.

In summary, NAFTA has created a better environment for Ford, but it is not a dramatically improved environment. It has to be seen in the context of the market volumes in North America and in the context of the world environment, but it is a very useful beginning. I think that over time the Mexican market is going to grow and prosper, and Mexican citizens are going to have higher per capita GDP to be able to spend on all products, including, I hope, Ford vehicles.