8.1 Intra-Industry Trade in Action: The North American Auto Pact of 1964 and the North American Free Trade Agreement (NAFTA)

An unusually clear-cut example of the role of economies of scale in generating beneficial international trade is provided by the growth in automotive trade between the United States and Canada during the second half of the 1960s. While the case does not fit our model exactly since it involves multinational firms, it does show that the basic concepts we have developed are useful in the real world.

Before 1965, tariff protection by Canada and the United States produced a Canadian auto industry that was largely self-sufficient, neither importing nor exporting much. The Canadian industry was controlled by the same firms as the U.S. industry—a feature that we will address later in this chapter—but these firms found it cheaper to have largely separate production systems than to pay the tariffs. Thus, the Canadian industry was in effect a miniature version of the U.S. industry, at about 1/10 the scale.

The Canadian subsidiaries of U.S. firms found that small scale was a substantial disadvantage. This was partly because Canadian plants had to be smaller than their U.S. counterparts. Perhaps more importantly, U.S. plants could often be “dedicated”—that is, devoted to producing a single model or component—while Canadian plants had to produce several different things, requiring the plants to shut down periodically to change over from producing one item to producing another, to hold larger inventories, to use less specialized machinery, and so on. The Canadian auto industry thus had a labor productivity about 30 percent lower than that of the United States.

The Ambassador bridge connects Detroit in the United States to Windsor, Canada. On a typical day, $250 million worth of cars and car parts cross this bridge.

In an effort to remove these problems, the United States and Canada agreed in 1964 to establish a free trade area in automobiles (subject to certain restrictions). This allowed the auto companies to reorganize their production. Canadian subsidiaries of the auto firms sharply cut the number of products made in Canada. For example, General Motors cut in half the number of models assembled in Canada, however, the overall level of Canadian production and employment was maintained. Production levels for the models produced in Canada rose dramatically, as those Canadian plants became one of the main (and many times the only) supplier of that model for the whole North American market. Conversely, Canada then imported the models from the United States that it was no longer producing. In 1962, Canada exported $16 million worth of automotive products to the United States while importing $519 million worth. By 1968, the numbers were $2.4 and $2.9 billion, respectively. In other words, both exports and imports increased sharply: intra-industry trade in action.

The gains seem to have been substantial. By the early 1970s, the Canadian industry was comparable to the U.S. industry in productivity. Later on, this transformation of the automotive industry was extended to include Mexico. In 1989, Volkswagen consolidated its North American operations in Mexico, shutting down its plant in Pennsylvania. This process continued with the implementation of NAFTA (the North American Free Trade Agreement between the United States, Canada, and Mexico). In 1994, Volkswagen started producing the new Beetle in Puebla, Mexico. This plant now produces all the new model versions of the Golf, Jetta, and Beetle for the entire North American market. In 2011, Volkswagen reentered the U.S. market with a new assembly plant in Chattanooga, Tennessee, where all Passat models for the North American market are produced (they were previously imported from Europe). We discuss the effects of NAFTA in more detail later in this chapter.

8.2 Antidumping as Protectionism

In the United States and a number of other countries, dumping is regarded as an unfair competitive practice. U.S. firms that claim to have been injured by foreign firms that dump their products in the domestic market at low prices can appeal, through a quasi-judicial procedure, to the Commerce Department for relief. If their complaint is ruled valid, an “antidumping duty” is imposed, equal to the calculated difference between the actual and the “fair” price of imports. In practice, the Commerce Department accepts the great majority of complaints by U.S. firms about unfair foreign pricing. The determination that this unfair pricing has actually caused injury, however, is in the hands of a different agency, the International Trade Commission, which rejects about half of its cases.

Economists have never been very happy with the idea of singling out dumping as a prohibited practice. For one thing, setting different prices for different customers is a perfectly legitimate business strategy—like the discounts that airlines offer to students, senior citizens, and travelers who are willing to stay over a weekend. Also, the legal definition of dumping deviates substantially from the economic definition. Since it is often difficult to prove that foreign firms charge higher prices to domestic than to export customers, the United States and other nations instead often try to calculate a supposedly fair price based on estimates of foreign production costs. This “fair price” rule can interfere with perfectly normal business practices: A firm may well be willing to sell a product for a loss while it is lowering its costs through experience or breaking into a new market. Even absent such dynamic considerations, our model highlighted how monopolistically competitive firms have an incentive to lower their markups in export markets due to competition effects associated with trade costs.

In spite of almost universally negative assessments from economists, however, formal complaints about dumping have been filed with growing frequency since about 1970. In the early 1990s, the bulk of anti-dumping complaints were directed at developed countries. But since 1995, developing countries have accounted for the majority of anti-dumping complaints. And among those countries, China has attracted a particularly large number of complaints.

There are two main reasons behind this trend. First and foremost has been China’s massive export growth. No firm enjoys facing stiff increases in competition, and anti-dumping laws allow firms to insulate themselves from this competition by raising their competitors’ costs. Second, proving unfair pricing by a Chinese firm is relatively easier than for exporters from other countries. Most developed countries (including the United States) facing this surge in Chinese exports have labeled China a “non-market” economy. A BusinessWeek story describes the difference that this description makes when a U.S. firm files an anti-dumping complaint against a Chinese exporter: “That means the U.S. can simply ignore Chinese data on costs on the assumption they are distorted by subsidized loans, rigged markets, and the controlled yuan. Instead, the government uses data from other developing nations regarded as market economies. In the TV and furniture cases, the U.S. used India—even though it is not a big exporter of these goods. Since India’s production costs were higher, China was ruled guilty of dumping.”[[1]](#footnote-1)

As the quote suggests, China has been subject to antidumping duties on TVs and furniture, along with a number of other products including crepe paper, hand trucks, shrimp, ironing tables, plastic shopping bags, steel fence posts, iron pipe fittings, saccharin, and most recently solar panels. These duties are high: as high as 78 percent on color TVs and 330 percent on saccharin.

1. “Wielding a Heavy Weapon Against China,” BusinessWeek, June 21, 2004. [↑](#footnote-ref-1)