Foreign Policy and the US Automotive Industry: By Virtue of Necessity?

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Newly Virtuous Strategies and their Unintended Consequences

Foreign imports had not only captured the small car market, they were expanding it, with the top brand selling 600,000 units a year. This was too much for the Big Three (General Motors, Ford and Chrysler) to ignore. Compact cars carried thin margins, and since entry by one of the Big Three would generate entry by all, they had comprised a niche market too small to be profitable. But the market had now shifted, necessitating a strategic response. Rather than making small cars, however, the Big Three turned to Uncle Sam for help. But this was 1968, not 1980. And the help they sought was not for protection, but because the Japanese government prohibited foreign investment in the industry, while the Big Three wanted to take an equity stake in their OEM suppliers. With stable foreign partners, the Big Three could then import small cars to limit the inroads of the Europeans, and above all the Volkswagen Beetle.

That effort proved doubly successful. Japan agreed to eventually open up investment. Ironically, however, Mitsubishi Heavy Industries struck a deal with Chrysler well ahead of the liberalization schedule, in effect calling the bluff of the Japanese government. A bluff it had been: the government caved in, calling into doubt the necessity of diplomacy.[2] But from another perspective the policy worked, in that the European invasion was pushed back, and the small car market shrank—as had happened twice before in the postwar era—justifying the Big Three decision not to enter production themselves.

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[1] My initial research was a chronological survey [Smitka, 1997]. Comments at the Association of Japanese Business Studies pushed me to develop this analytic treatment. I also benefited from comments on a Japanese-language version from seminars at Hiroshima City University, the Institute of Social Sciences of the University of Tokyo, the International University of Japan, and the Japanese International Economics Association, as well as from discussions with the staff of Toyota's Government & Public Relations Department.

[2] Chrysler agreed to take a 35% stake in Mitsubishi Motors in 1970, above the 1/3rd threshold that under Japanese corporate law guarantees voice in management. (Chrysler ran into financial trouble soon thereafter, and bought only 15%, which they sold in 1992 when they again ran into financial straits.) GM likewise took a 34% stake in Isuzu in the early 1970s, and a 5% share of Suzuki. (GM plans to increase these stakes during 1999.) Ford bought 25% of Mazda in 1978, later increasing their holdings to over 33% and installed their own management team.

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By 1980 the industry had lost its reticence about seeking government help, in the face of an admittedly greater influx of small cars during a sharp recession, successfully pushing the Reagan Administration in 1981 to negotiate a voluntary export restraint (VER) with Japan. Why not be patient, as in the past? Much else had changed besides the economic context. New political balances, a changed union movement, new institutions and attitudes towards trade–and, by the 1990s, senior management with international background–all came together to produce 15 years of trade disputes with Japan. While done in the name of virtue, however, the net result was of dubious value to the Big Three themselves, contributing to the end of their 60 years of oligopoly. Such misplaced virtue likewise entailed social costs, since it led to new entry that entailed not merely a shift of employment to new firms (while leaving total employment little changed), but a shift to new geographic areas, uprooting millions of lives.

This paper traces the shifting balances that led to the negotiation of the 1981 VER (voluntary export restraint) with Japan. The activist stance, however, did not end then. The "temporary" VER itself lasted until 1994, and the industry pushed subsequent trade issues with Japan, including the 1986 MOSS (market-oriented sector-specific) auto parts talks, the 1992 Bush voluntary purchase agreement (tied loosely to the Structural Impediments Initiative), and the 1994-95 Framework Agreement spat under Clinton.[3]

The Old Balance in Politics, Ideology and Trade

The activism of the 1980s and 1990s is in sharp contrast to the almost total disengagement of government and business in the 1930s [Machado, 1999]. That pattern continued into the 1970s, when foreign policy involvement was ad hoc and often accidental. In the initial post-WWII era most direct involvement was related to restrictions on local investment by the Big Three, particularly in Mexico. But the industry was also caught up in the 1963 "chicken war" with the European Community over US exports of frozen poultry. One of a series of narrowly targeted American reprisals was the imposition of a "temporary" 25% tariff on light trucks, aimed at the modest sales of VW vans in the US. The automotive component was an afterthought, the German item alongside French cognac, Danish hams and Dutch cheese. The impact turned out to be substantial, because that "temporary" tariff is still in place 35 years later, and in the interim helped the Big Three keep a lock-grip on the lucrative pickup truck market.

Likewise, a 1964 countervailing duty suit against a Canadian tariff rebate scheme by Modine, a Wisconsin-based radiator manufacturer, threatened to set off a trade war with our closest neighbor. It was resolved in the Auto Pact of

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[3] The industry was later active in the negotiations over the terms of the North American Free Trade Agreement, it pushed for domestic content labeling, and had a hand in tariff classification lawsuits, luxury taxes, and the rules for CAFE (corporate average fuel economy). It also monitored the use of safety and environmental issues as non-tariff barriers, as well as continuing to push for investment liberalization in foreign markets [Smitka, 1997].

1965, the first significant free trade agreement between the US and Canada, which eliminated tariffs on bilateral vehicle and automotive parts trade. This permitted a rationalization of assembly inside Canada, with mass production plants producing models for the combined US and Canada market replacing a hodgepodge of inefficient factories turning out small volumes of multiple models solely for Canada. While relatively unimportant for the operations of the Big Three in the US, it vastly increased the scale of assembly within Canada and of Canadian exports (even while the auto parts sector declined). In the end, the political success of the Auto Pact paved the way for the 1988 US-Canadian Free Trade Agreement and ultimately for NAFTA. Again, foreign policy of modest import for the domestic US market turned out in the long run to have significant–and here again positive–consequences.

This overall passive stance had many sources. First, the production strategy of the Big Three, dating from before WWI, was to build in each local market rather than export. Trade policy did not matter–transport costs were high, and tariffs in many foreign markets were effectively taken as a given–though foreign investment rules were of potential concern. That imports were a small share of the Big Three's home market reinforced this trend.

Second, neither management nor labor were protectionist in orientation. The United Auto Workers was the last major union to support free trade, keeping that position into the early 1970s. Corporate management was likewise oriented toward free trade, when they thought about trade at all. For while Henry Ford II may have fancied himself a member of the European jet-set, the operations of Ford and GM in Europe were run virtually independent of North American operations. Most managers were local, and by the time the handful of expatriate managers rotated back to headquarters in Detroit and Dearborn, they were outside the loop for the top posts. International issues were not viewed as central to corporate strategy.

Third, trade policy was not a useful tool for politicians, or at least congressmen from the Midwest. The industry elicited no interest in foreign affairs, and for that matter union votes could be taken for granted by the Democrats who dominated Detroit and other urban districts. Trade was a small share of the national economy, trade policy was run by powerful committee chairmen, and protectionism had little intellectual support. The same was true at the presidential level: trade policy did not buy union support–indeed, Democrats could take union support for granted, and did not have to curry favor.

The New Balance in Politics, Management and Ideology

These balances began shifting in the 1970s, and by the 1980s the old policy environment disappeared: trade activism was viewed as beneficial, if not virtuous, by major players, including labor, management, and politicians. In the mid-1970s the UAW finally sided with the rest of the US labor movement in opposition to free trade. Indeed, in the 1980s and 1990s trade activism was one (but far from the only) tool in the ascent of new leaders, as the founding gen-

eration of the union passed from the scene. Second, management changed their stance. Circa 1980 they were driven to that by massive financial losses that saw the near-collapse of Chrysler, while Ford was saved only by the profitability of their European operations.[4] By the latter 1980s management at the Big Three took on a very different character: all of the top managers had substantial international experience. Indeed, the past two CEOs of Ford both grew up and began their careers outside the United States. International experience was no longer a hindrance in the road to the top, and the new generation of automotive executives was socialized into the much more politicized world of the European auto industry. It was natural to work with government.

Politics also changed. Suburbanization saw the core membership of the UAW move out of the cities, and take on a far more conservative bent. Republicans could realistically vie for the union vote. But most local elections are barely contested,[5] and so where trade issues really stood out was in the run-up to presidential campaigns. This was true both in general elections and (for incumbents) primaries, where Democrats needed union money and (with lower expectations!) union votes. In the meantime trade has grown as a share of the economy–roughly doubling during the 1970s–while ballooning American trade deficits have made it a more salient issue. During this period the power of committee chairmen also declined, giving individual congressmen greater voice.[6] In short, automotive trade issues were seen by some politicians as useful for their own narrow electoral purposes. Besides, the new trade theory–at least in the hands of non-economists–seemed to make free trade passé. If the Japanese could succeed by protecting key industries, then why couldn't we?[7]

The Big Three had long had offices in Washington, as had the AFL-CIO and the United Auto Workers. The Clean Air Act of 1970, the rise of NHTSA (the National Highway Transport Safety Agency), CAFE (corporate average fuel economy) rules and other "social" legislation [Aaronson, 1999] made their function far more important. Consequent organizational and personnel changes facilitated the exercise of voice in Washington on other matters, such

[4] GM, which continued to generate profits, was not an enthusiastic supporter of the VER. Part of this may have been due to the personal stance of Marina von Whitman, GM's chief economist and a vocal free trader. In addition, GM's Japanese affiliate, Isuzu, was just bringing a new assembly plant into production that was dedicated to the making small cars for export to the US (to be sold by GM as Geos). The VER, which initially allocated quota entitlements on the basis of past exports, threatened the viability of this major investment.

[5] I could locate no patterns in the voting for Congressional seats–incumbent effects appear to swamp any marginal changes in party orientation–and so this assertion rests upon my personal impression of the course of change in the Detroit area, where I grew up. Other data sources were also dead ends–the legislation enabling PACs dates from 1975, and so the data that generated does not go back far enough for my purposes.

[6] See Destler [1995] on changing congressional institutions in trade policy formation.

[7] In contrast to the "revisionist" literature, I argue that the Japanese economy grew despite harmful trade policies, not because of them. Likewise, the new trade theory, of which Paul Krugman is the best-known proponent among non-economists, makes very narrow claims about the conditions under which policies other than free trade are both theoretically desirable and empirically tractable. Krugman himself strenuously advocates free trade.

as trade policy. The apogee of this trend came with the dissolution in 1992 of the Motor Vehicle Manufacturers Association–the auto firms' industry association, which included Honda. It was succeeded by the American Automobile Manufacturers Association, comprised solely of the Big Three, and headed by Andrew Card, a high-profile former Secretary of Transportation, who moved the headquarters from Detroit to Washington.[8] In the political climate of the time, Lee Iacocca had ready access to the White House; indeed, the heads of the Big Three trekked to Little Rock to meet with Bill Clinton in 1992, even before his inauguration. That pattern–direct presidential involvement–in fact is common across the major post-1970 trade spats with Japan.

The Timing of Trade Disputes

If the increase in trade disputes is due primarily to non-economic factors, then the timing should also reflect political factors. In fact, since the mid-1970s it has been closely aligned with the presidential election cycle (and, notably, not with mid-term Congressional elections).

By the mid-1970s the Big Three were clearly high in cost and poor in product quality; the U.S. had in fact been a net importer since 1957.[9] Nevertheless, foreign firms were slow to enter the U.S. market–it was costly to set up a national dealership network, while Americans favored cars much larger than those driven by Japanese or Europeans. Until the oil crises of 1973 and 1979 their sales never exceeded 10% of the market, and were typically much less. But the shift in demand toward subcompacts led to a flood of imports.

Given the rise in imports, the Big Three explored filing an antidumping suit in 1975, but oil prices fell in 1976 and the effort was dropped. With the second oil crisis, however, imports from Japan and Europe rose again, from 2.0 million units in 1978 to 2.5 million units in 1980. This, though, coincided with the onset of a sharp recession, and more importantly with the run-up to the 1980 presidential elections. By 1980 the import share had jumped from 18% to 27%, while Chrysler teetered on the brink of bankruptcy, and Ford was kept afloat only by high European profits; even GM resorted to layoffs. Limiting imports offered a quick fix–which Carter refused to do, offering only Trade Adjustment Assistance as a sop to the unions. Ford and the UAW then filed a Section 201 "escape clause" suit, but the ITC's deadline slipped to November, too late to be used in the election. In the end it released a negative finding, blaming industry problems on the recession rather than imports. The incoming Reagan administration thus faced immediate pressure to do something. In

[8] The AAMA dissolved in 1998, when the merger of Daimler Benz and Chrysler rendered unviable its "American" exclusivity. The successor organization will incorporate foreign firms besides DaimlerChrysler, and influencing trade policy will no longer be one of its goals.

[9] As Mira Wilkins phrased it, "Once, U.S. automobile companies had world leadership in technology; once they had a truly unique product, the mass-produced cheap car; then, they had exported the vehicle and had made investments to sell (and then to assemble and to manufacture) the car abroad....By 1957, the United States changed from its historic position as a net exporter to a net import of *passenger* vehicles." [Wilkins 1974, p. 377].

1981, even before nominees were in place, legislation to restrict imports was introduced into the new Congress, and by April Senator Danforth (R, MO) claimed to have the votes.[10] The new administration took this at face value, and hurriedly hammered out a 3-year VER with Japan effective May 1981. An era of U.S. protectionism in the industry had begun.[11]

As hoped, the VER led to an immediate jump in car prices, both imported and domestic; helped by the recession's end, by 1983 the Big Three returned to profitability. The Japanese, however, reaped tremendous profits from the start: in effect the U.S. government had asked them to form a cartel, and they obliged. The government may have viewed the VER as a crisis, but for the Japanese car companies the VER meant $4 billion a year in excess profits during 1981-1985, from what was in effect a tax on American consumers of $1500 per new car. These profits in turn helped the Japanese finance the development of upscale vehicles, and hence maintain their presence in the market when Americans began moving to the purchase of larger cars.[12]

The UAW voiced hopes that the Japanese would invest in U.S. facilities, providing jobs. The Big Three were convinced they had little to fear from such operations, expecting that (as at Volkswagen's short-lived Pennsylvania plant) foreign firms would lose their cost and quality advantages once forced to produce with American workers. Honda, which opened the initial Japanese "transplant" operation in Ohio in 1982, proved them wrong, achieving high quality and high productivity from the start. It was soon joined by Nissan, and by 1995 eight Japanese and two German car makers had built 2.9 million units in new assembly capacity, 20% of normal U.S. sales. (Capacity continued to expand, and in 1999 these new entrants produced 3.5 million cars and light trucks.) The VERs thus stimulated new entry that brought about a permanent end to the Big Three's comfortable oligopoly, with predictable consequences for profitability.[13]

These new plants were spread across 9 different states and Ontario, rather than on the UAW's home turf. New, more efficient plants displaced older facilities, at tremendous cost to workers, and cutting UAW rolls by a half million members. The initial wave of assembly transplants was thus followed by a tide of suppliers. Europeans joined in, accounting for about 150 ventures, while Japanese firms added nearly 300 plants by the late 1980s. Again, much of this production displaced existing producers.

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[10] The votes may not have been there. The Washington lobbyist for one auto maker filed an analysis showing that legislative support was thin, but that report was buried and he was fired [interview, Lawrence Krause, 1992].

[11] VERs continued at varying levels for a dozen years, until April 1994. Imports peaked in 1985, and from 1986 on the VER was not binding.

[12] A senior member of Toyota's government relations section claimed they did not at first realize how profitable the VER would be, and fought it bitterly. Toyota benefited as an early entrant, since the VER was allocated among Japanese firms on the basis of US market share. As noted above, firms just entering the market, such as Isuzu, had reason to complain.

[13] Despite the 1998 boom in the US, no firm achieved a 5% profit margin on sales. In contrast, from 1947-1965 profits averaged 15% of sales at GM, 10% at Ford and 8% at Chrysler.

Ironically, this outcome was a function of trade policy. The Japanese transplants planned their factories in the mid-1980s, when the dollar was strong and compact car sales strong. From September 1985, however, the yen jumped from ¥240 per dollar to under ¥100 per dollar in 1994. The appreciating yen steadily pushed up prices, and sales of imports fell every year from 1986 to 1998. But for the VER, the Japanese would not have built their "transplant" assembly operations and would have been slower to develop mid-market and luxury cars. In all likelihood they thus would have been squeezed out of the market, leaving Big Three dominance intact. Consumers paid a high price up front due to the VER, but ultimately benefited from enhanced vehicle quality and product variety. But neither existing American producers nor labor unions benefited, even though in 1999 industry capacity and employment were at historic peaks.[14]

Politically, structural change resulted in pressure to shift the terms on which direct investment took place. In auto parts, this began with the 1986-87 MOSS (market-oriented sector-specific) talks with Japan, again falling in the run-up to a presidential election. The real aim was to pressure the Japanese transplants to purchase parts from American firms, rather than to import them from Japan. Formally, however, the talks sought to open up the Japanese domestic market, focussing on regulations and certification that effectively excluded imported OEM and replacement parts. While Japanese purchases from American suppliers now total more than $22 billion per annum, most of those purchases are by "transplant" operations in the U.S. (parts exports to Japan are $2 billion) while "American" suppliers include new European- and Japanese-owned factories, and in fact many "traditional" suppliers saw their businesses shrink.

Nevertheless, increasing Japanese parts purchases continued as a formal element of U.S. policy, and became an issue again in the next president cycle. This was most visible in the lead-up to the January 1992 Bush-Miyazawa Tokyo summit, the first to Japan after the end of the Cold War. Initially few economic—and no automotive issues—were on the agenda, but after a surprising loss by Dick Thornburgh, Bush's former Attorney General, in a November 1991 by-election for an open Senate seat in Pennsylvania, the White House was thrown into a panic, and began to talk of "jobs, jobs, jobs." Just before the Christmas holidays (in Japan, the New Year holidays), autos were put on the agenda, to the considerable consternation of State Department officials (not to mention their Japanese counterparts!). The Japanese auto firms "volunteered" (in individual letters, without a formal government role) to sell a token number of Big Three cars, and to increase purchases of American parts from the existing level of $9 billion annually (fiscal year 1990) to $19 billion in FY1994. In fact, however, the Japanese government lacked leverage, and the firm-by-firm goals were merely a public version of internal projections. The increase, then, reflected

[14] Indeed, as of end 1998 employment was at record levels, helped by the recovery in total output and the increasing complexity of vehicles—a sharp rise in employment at suppliers more than compensated for a fall in assembler employment.

objective economic factors: the doubling of the yen after 1985 and the rapid increase in volume in cars built at the auto makers' American plants. So while the agreement garnered media attention, it was not economically meaningful.

Auto parts continued on the bilateral agenda, included as one sector in the July 1993 "U.S.-Japan Framework Agreement." Little progress was made in these talks, however, until the start of the next presidential cycle, roughly 4 years after the failed Bush summit. The two governments declared a formal stalemate in early 1995, with issues ranging from the "objective criteria" to be used to gauge progress, to antitrust and regulatory issues within Japan that impeded the aftermarket sales of other than "original" parts. Such a situation could not last in a presidential primary, and brinksmanship ensued, with 100% tariffs threatened on Japanese luxury cars. This time the Japanese budged only on select regulatory issues, refusing to agree to "voluntary" parts purchases or other measures not directly in the control of the government. In the process Ryutaro Hashimoto gained prominence in Japan for his confrontation with Mickey Kantor, eventually helping him gain the prime ministership. The Clinton administration claimed victory, releasing letters in which the U.S. government "projected" the number of new Big Three dealerships in Japan and other targets, all formally disavowed by the Japanese. Absent the US election cycle, it is hard to fathom why the president would involve himself so prominently in failed trade talks, or engage in such contortions to save face. But the UAW was visibly appreciative of his efforts, and their funding and activism helped the Democrats. Mission accomplished?

Conclusion

Increased corporate activism in the context of the four-year cycle of American trade activism bodes ill for the future. For the year 2000 election, however, autos would seem to be a poor candidate. Employment is at record levels, and output is high. Japan is mired in recession, and if they are not buying their own cars, how can they realistically expect to buy American vehicles? Capacity is in any case strained: we could not export more than a token number due to supply constraints. Furthermore, Japanese firms are no longer seen as making further inroads into the former Big Three's market–and Chrysler is no longer "American." The AAMA has collapsed, to be replaced by an association that includes Japanese and German producers. The president of Mazda is from Ford, and the latter cannot credibly claim lack of access to Japanese dealers. Perhaps trade is a less potent issue for automotive management, for unions and for politicians, at least in the auto industry. But in early 1999 steel obtained a VER from Japan, Brazil and Russia, a return after a several year hiatus to a pattern of protection that dates back to the Trigger Price Mechanism of 1977. Hence the presidential cycle is reflected in trade policy, even if the auto industry is not on the agenda.

This raises the question of how representative the auto industry is of American industry in general. Such activism seems in fact to be the exception,

not the norm.[15] It comprises an element of corporate strategy steel, semiconductors, and telecommunications, but historically such activities pale beside the role of textiles and agriculture in trade policy, where individual producers played little or no role. Internationally, close government involvement has typified the auto industry in Europe, where the major markets of Germany, France, Italy and the UK were all dominated by national "champions." (Indeed, Ford and GM were in some ways the only "European" firms, whose identities were not tied to a single country.) Japan, of course, was no exception, and the political timing of disputes does not preclude the presence of substantive issues. Furthermore, European governments negotiated their own complicated set of quotas and VERs with Japan (that, unlike the US, included restrictions on "transplant" factories), while in 1997 Japan took the lead in filing a automotive case against Indonesia with the World Trade Organization over preferences for a national "champion" producer. Such activism is new in Japan, and may reflect a similar evolution of corporate strategy and domestic politics. But it would require much additional research to delineate the timing and content of changing foreign policy and corporate strategy in the auto industry in other countries.

The growth of corporate activism in trade policy, however, should also provide a sober reminder of the difficulty of foreseeing the implications of strategy. It is apropos to cite the opening rumination of former GM President "Engine" Charlie Wilson at his 1953 confirmation hearings as Eisenhauer's Secretary of Defense: "For years I thought that what was good for the country was good for General Motors, and vice versa." Trade activism proved a mixed blessing for the US, leaving us with a more efficient industry albeit at considerable social cost, but has been an unmitigated disaster for GM, whose decline in US market share closely matches the increase in share of the new entrants.

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[15] This opinion was seconded by Glen Fukushima, President of the American Chamber of Commerce of Japan, and a former United States Trade Representative lawyer and Japan lobbyist for AT&T [interview, Tokyo, May 1998].