**EXPLAINING THE DECLINE IN CANADIAN AUTO PRODUCTION IN 2013**

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**Highlights**

- While auto sales and production are up in North America in 2013, Canadian auto production has bucked the trend, falling 7% during the first half of the year.

- However, the underlying details do not appear to be as dire as the headline figure suggests. In fact, there are a number of factors that have led to this decline.

- While some of the downward influence will likely subside next year, a further dip appears to be in slate. Overall, we expect Canadian light vehicle output to fall 4-5% in 2013 and 2014.

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North American auto sales are running high this year, as they continue to make great strides since the dark days of the recession. Continent-wide sales are on track to increase for the fourth consecutive year. In the largest of these markets, U.S. sales are averaging north of 15 million units (on a seasonally adjusted annualized basis) for the first time since 2007, hitting a peak of 15.8 million units (SAAR) in June. The robust recovery in sales has extended to the production side of the equation as well. Light vehicle production was up 4% over the January-June period across the continent, with capacity utilization running at 103.3% in the second quarter of 2013.

Yet, somebody forgot to pass the message along to the Canadian auto assembly sector. After rebounding strongly following the recession, light vehicle output has bucked the trend in 2013, falling 7% during the first half of the year. This figure is in stark contrast to the gains seen south of the border, where production is up 6% in the U.S. and 5% in Mexico. Barring a dramatic turnaround in the coming months – which we don’t expect – this puts Canada’s auto sector on track to record its largest annual decline outside a recessionary year going back to 1990.

**What’s going on in Canada?**

Five automakers have assembly plants located in Canada. As shown in Table 1, the performance to date has been underwhelming across the board. Production is down at GM, Toyota and Chrysler, while Honda’s output is flat and Ford’s is slightly higher.

However, digging a little deeper, the underlying details do not appear to be as dire as the headline figure would suggest. In fact, there are a number of different reasons behind the slump in output among the different automakers.

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Looking at Toyota’s Canadian manufacturing operations, it appears as though the Corolla is the main culprit behind the slide in vehicle assemblies. Interestingly, the automaker’s new plant in Blue Springs, Mississippi has seen an increase in Corolla production of roughly the same magnitude as the drop seen in Canada. While this could be viewed as a knock on Canada, it is important to remember that the Corolla was previously also built in Toyota’s Fremont, California plant, prior to its closure in 2010. To make up for this reduction in capacity, production of the Corolla in Canada jumped by 47% from 2009-2011. Hence, it appears as though this is more of a return to a two-plant North American production arrangement which is fairly standard for popular models, in light of the benefits of diversification. Indeed, of the top 10 selling vehicles in the U.S. in 2012, only two are currently manufactured at a single North American plant. Moreover, Toyota is the only automaker that has recently expanded capacity in Canada. Its second Canadian plant, in Woodstock, Ontario – which opened in 2008 and has seen production rise from 78,000 units in 2009 to 178,000 units in 2012 – received an additional investment in 2012 to raise production to 200,000 vehicles/year. This should partially mitigate the decline seen in Corolla production.

Another reason for the underperformance seen in Canadian auto assembly output in 2013 perhaps results from the types of vehicles manufactured there. The hottest selling high volume segment in the U.S. this year has been large pickups – up 22% YTD – which Canada does not produce. Chrysler’s performance reflects this issue, as its Windsor, Ontario plant solely builds minivans, and sales of the Dodge Caravan are down in both Canada and the U.S. in 2013. Furthermore, production of the Volkswagen Routan (which Chrysler manufactures there) has been slashed as the vehicle is slated to move to fleet-only status for 2014. On the bright side, increases in the Chrysler Town & Country and Dodge Challenger output are providing some offset.

Finally, the drop in GM’s output largely reflects the winding down of the Oshawa 2 plant which is slated to close in mid-2014. As part of the process, a portion of the Equinox and Impala production has been shifted to plants in the U.S.. As of July, the automaker is running only one shift at the plant. While the impending plant closure will lead to lower output in Canada, GM earlier this year did announce a $250 million investment to turn its CAMI plant in Ingersoll, Ontario into a flexible manufacturing facility. This bodes well for future production in Canada, as it will allow the plant to handle a greater variety of vehicles.

On a more positive note, Ford has increased production this year, largely due to a jump in Ford Edge assemblies, as sales of the vehicle are up 7% in the U.S. so far in 2013. Moreover, while still too early to get excited, Ford is considering an expansion of its Oakville, Ontario plant, pending government aid, which could provide a boost to production.

The overall decline in Canadian auto production relative to its North American counterparts raises the question of whether Canada is suffering from growing competitiveness issues. While there are a number of different factors weighing on auto manufacturing in Canada that are not related to competitiveness, the fact remains that new investment on this side of the border is lacking. As a result, Canada’s share of North American light vehicle production has declined – it currently stands at 14.6% YTD in 2013, relative to a 16.6% average over the 2000-2010 period. Part of this decline comes down to increased growth of vehicle manufacturing in Mexico, where the cost structure is lower and there is greater access to the growing Latin American markets. However, even the U.S. is seeing increased investment activity among automakers, thanks in large part to government incentives.

<table>
<thead>
<tr>
<th>Auto Manufacturer</th>
<th>2013</th>
<th>2012</th>
<th>% Chg.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chrysler</td>
<td>284,851</td>
<td>303,395</td>
<td>-6.1</td>
</tr>
<tr>
<td>Ford</td>
<td>132,820</td>
<td>128,858</td>
<td>3.1</td>
</tr>
<tr>
<td>GM</td>
<td>318,571</td>
<td>360,114</td>
<td>-11.5</td>
</tr>
<tr>
<td>Honda</td>
<td>216,433</td>
<td>216,146</td>
<td>0.1</td>
</tr>
<tr>
<td>Toyota</td>
<td>248,461</td>
<td>279,755</td>
<td>-11.2</td>
</tr>
</tbody>
</table>

Some steps have been made to close the cost gap with the U.S. market, including the latest labour contract signed by the CAW, as well as past cuts in corporate income taxes by federal and provincial governments. The recent fall in the Canadian dollar from above parity to just under 97 US cents – and prospects for further declines over the next 6-12 months – should also be of benefit, although not nearly as much as it was a decade ago when the loonie was trading below 65 US cents. Nonetheless, more needs to be done to even the playing field if Canada wants to attract more investment within the industry.

Is the trend set to continue?

While the picture is not as bleak as it would seem, the end result is that production in Canada is down in an era of rising vehicle sales. Going forward, while it is not possible to ascertain the exact intentions of automakers, a further decline – albeit a more moderate one – appears to be in the cards over the remainder of 2013 and 2014. The gradual shutdown of GM’s Oshawa 2 plant will continue to weigh on Canadian light vehicle production over the remainder of this year and in 2014. However, it will be partially offset by rising production of the 2014 Impala at the Oshawa 1 plant. Elsewhere, auto manufacturing will likely depend on demand for the vehicles built at Canadian plants, as well as their corresponding inventory levels. Fortunately, the recovery in auto sales in the U.S. is expected to continue, driving sales towards the 16 million unit mark next year, which should ultimately bode well for Canadian auto manufacturers. That said, auto production in Canada is expected to largely underperform its North American counterparts this year and next, with output sliding 4-5% per year, compared to mid-single digit gains in the U.S. and Mexico.

The slowdown in light vehicle assembly output has also been felt in the auto parts sector. Motor vehicle parts manufacturing was down 7% in real output terms during the first five months of the year. However, the picture is not all gloomy. Other areas of manufacturing are benefiting from the rise in vehicle sales, and perhaps more specifically, the vast amount of new models hitting (or recently hit) the market over the next 2-3 years. The tool, mould, die, and machining sector has been on an upswing, and is likely to thrive over the next few years as new models are rolled out. This has been a positive development for the city of Windsor, Ontario, which has a large auto tooling manufacturing industry.

Bottom Line

Vehicle sales across North America are set to hit a new post-crisis high in 2013, surfing off a renewed wave of confidence in the U.S., and pent-up demand from years of sub-trend sales. However, Canadian vehicle production has been losing ground, and while some of the downward influence will likely subside next year, a further dip in output appears to be in slate. This stands in stark contrast to the rest of North America, where automakers are increasing capacity and production in both the U.S. and Mexico. Prospects for a lower Canadian dollar might help to stabilize Canada’s share of North American auto assemblies over the medium term. But more needs to be done to even the playing field.

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Endnotes

1 Capacity is determined assuming a 52 week annual production schedule and two production shifts per plant. The capacity utilization rate is actual production as a share of total capacity.