OBSERVATION

TD Economics

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MANUFACTURING REBOUND BELIES COMPETITIVE CHALLENGES

Highlights

- The Canadian manufacturing sector has been enjoying a cyclical rebound from the recession over the past couple of years. However, there has been some disconnect between output and employment in the sector, as job gains have been quite scarce.
- While the sector will continue to recover, its share of the total economy is unlikely to gain much ground as many of the competitive challenges that were weighing on the sector prior to the recession remain in place.
- Manufacturers must step up their game in order to maintain and grow their footprint in the Canadian economy. Investing in innovative practices and technologies to increase productivity and contain unit labour costs would help to improve their competitiveness. As well, diversifying away from the U.S. and tapping other faster growing markets will increase the pool of potential buyers of Canadian-made goods.
- Overall, we expect manufacturing output and employment as a share of the national total to remain well below the peaks seen in 2000.

Canadians have been bombarded by seemingly mixed headlines on the state of Canada's manufacturing sector in recent months. For example, "Manufacturing output is rebounding strongly from recession", "Employment in manufacturing declines again", "Major plant closes its doors and plans relocation to the United States". This report attempts to clear some of the air by drawing on the most recent figures. In a nutshell, the story is one of a sector enjoying a cyclical recovery from the recession, but continuing to face significant longer-term challenges.

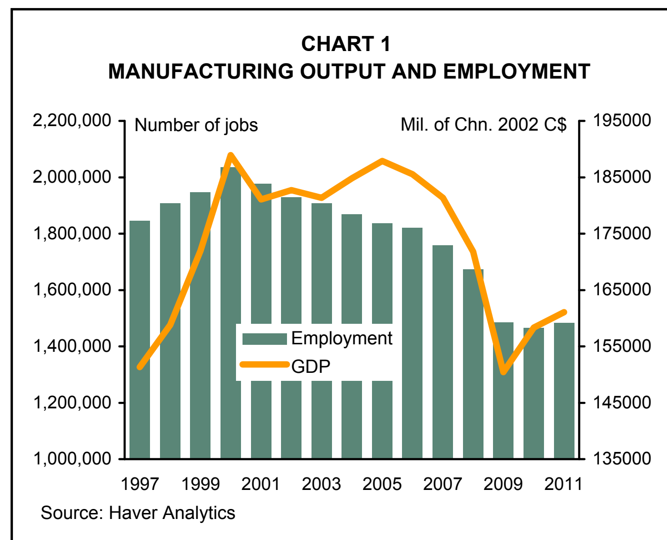
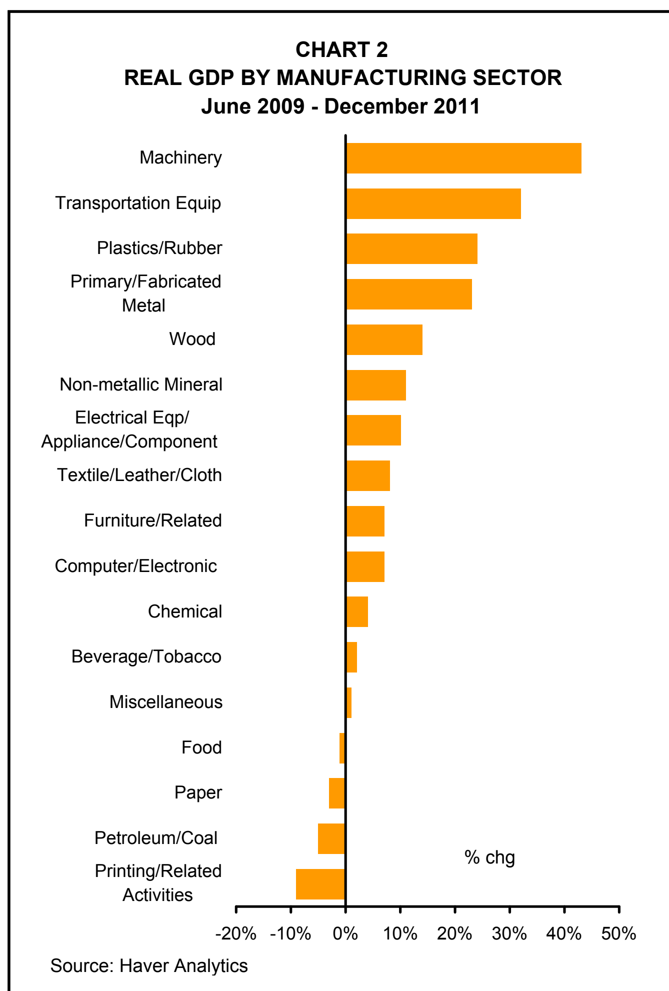


Chart 1 tells the story of how the manufacturing sector shrank from its peak in 2000 to the lows of the recession in 2009 – both in terms of output and employment. Prior to the recession, the declines were brought on by the fact that many of the conditions that were supporting the sector in the 1990's and the early part of the decade – including a loonie worth 60-70 US cents, low energy prices and relatively lower labour costs – have since turned into challenges. As well, the thickening of the U.S. border over the past 10 years has created additional headwinds for manufacturers who export their products Stateside.

Not surprisingly, the recession exacerbated the downtrend in both output and employment. However, consistent with some of the better news that has emerged recently, output has been claw-

Dina Cover, Economist, 416-982-2555

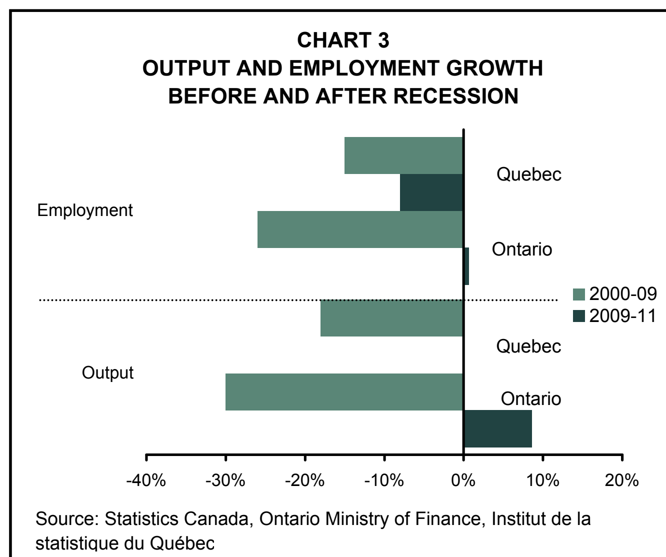


ing its way back with a rebound of 13% since mid-2009. As shown in Chart 2, industries that have been driving the manufacturing recovery are machinery and transportation equipment. Machinery is the only manufacturing industry where output has surpassed pre-recession levels – largely due to a 135% surge in construction, mining and oil and gas field machinery output. A resurgence of the auto sector underpinned the robust growth seen in transportation, as motor vehicle manufacturing has rebounded by over 90%. As of December, manufacturing output was sitting about 4% below pre-recession levels and its share of total output was 12.9% – down from a peak of 18% in 2000.

Unfortunately, employment has not fared so well, with only a third of the jobs that were lost during the recession recouped. As a share of total employment, manufacturing jobs currently account for fewer than 10%, compared to a peak of over 16% in 2000. Historically, there has been a very tight relationship between changes in output and employment in the manufacturing sector. But since the start of 2010, that relationship has been almost non-existent. Part of the disconnect can be linked to cautious hiring by businesses during the recovery, since the U.S. economy – where a large chunk of Canadian-manufactured goods are destined – has been improving at only a tepid pace and the global economic environment has become overshadowed with an enormous amount of uncertainty. Instead of growing their workforce, manufacturers have been using overtime to boost output, which can only last so long given the added cost.

One recent bright spot within the sector is food manufacturing – due in part to the fact that the country is rich in agricultural resources. Food processing was the only manufacturing sector to grow during the recession – likely the reason it hasn't been a key contributor to the recovery. And with 230,000 jobs, it employs more workers than any other manufacturing industry. What's more, despite a flat performance during the recovery on the output side, roughly a fifth of all manufacturing jobs gained over the past two years were in the food processing industry.

Needless to say, central Canada has suffered the largest declines in manufacturing activity over the past decade. While Ontario has enjoyed a stronger rebound following the recession (relative to a flat performance in Quebec), manufacturing output in the province remains more than 20% below the 2000 peak, while the comparable figure for Quebec is about 18%. Meanwhile, employment in Ontario edged up in 2011, while Quebec continued to shed manufacturing jobs over the past year. The sector's share of total employment was at a record low of 12% in both provinces last year.



Given that manufacturing is still recovering from the cyclical downturn, we expect the rebound in factory output to continue. But the pace of growth will be constrained by the same issues that were weighing on the sector prior to the recession.

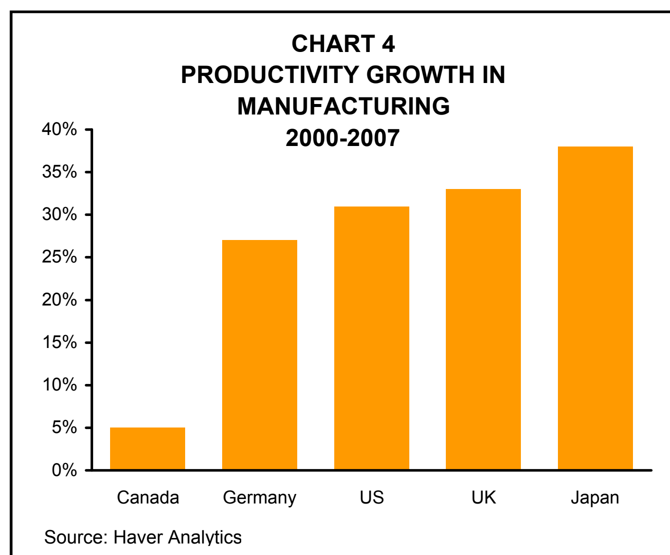
High-flying loonie here to stay

While some are quick to attribute the woes of the manufacturing sector to the appreciation of the Canadian dollar since 2002, there were other factors at play. Still, the exchange rate continues to be a significant headwind facing the sector. The Canadian dollar has been hovering in the 90 – 100 US cent range since mid-2009, and has remained there this year as foreign investors continue to ramp up their holdings of Canadian dollar denominated securities. What's more, this range is likely the new norm, with medium-term risks largely tilted to the upside. Indeed, talk of Dutch Disease – whereby increased demand and prices for resources underpin a stronger currency, leaving other goods exports much less competitive – had been silenced to some extent during the recession, but is now back. This challenge has left manufacturers facing a double whammy of a stronger dollar and higher input costs – particularly energy. While many businesses have likely adapted to this high-loonie, high-energy cost environment, it still constrains the competitiveness of Canadian manufacturers. Accordingly, these producers must continue to make headway in a number of other areas that they have more control over.

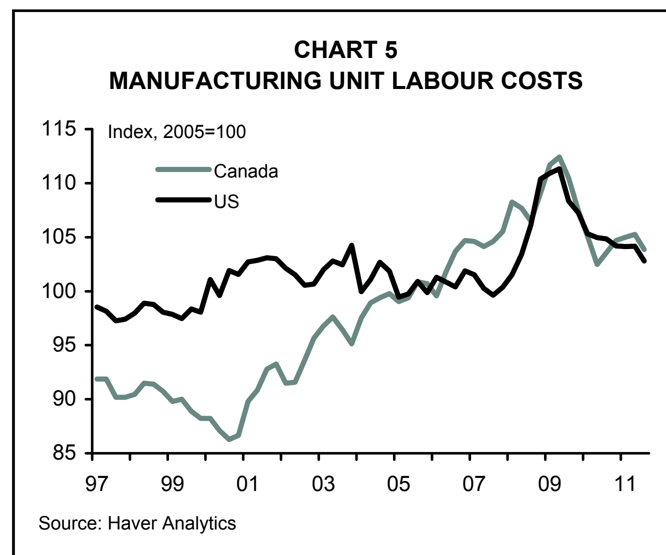
Higher productivity can help boost competitiveness

Over the longer haul, a desirable goal would be for producers to successfully compete based on innovation and high value added rather than purely on price. In the shorter term, however, attractive pricing becomes the more achievable lever. In turn, an ability to offer more competitive pricing boils down to either getting labour costs down (which are more under a firms control than many non-labour costs) or by increasing productivity. Unfortunately, growing productivity has been a challenge for Canadian manufacturers in recent years. Indeed, as illustrated in Chart 4, productivity growth in Canada's manufacturing sector during the 2000-07 period (prior to the recession) was 5%. This pales in comparison to other G-7 nations, where productivity grew by about 30%. After sliding during the recession, Canadian productivity has rebounded nicely, though at only a third of the rate seen in the United States.

Slower productivity growth has consequently left Canada with higher unit labour costs. As shown in Chart 5, 10-15 years ago, Canada had a significant cost advantage over the United States. But not only has that gap since closed, unit labour costs in Canada are now slightly higher than they are south of the border, with the competitive edge once enjoyed, now entirely eroded. This is a worrisome trend. With U.S. unit labour costs now following a declining path and with risks tilted towards an even higher Canadian dollar, Canada's relative cost position could deteriorate further. What's more, all in labour costs in the sector – including wages, benefits and taxes – are now higher in Canada, at $35.76 compared to $34.74 in the U.S.[1] , despite Canada's public health care system. In fact, some regions in the U.S. have even become more competitive with low-cost labour markets, with companies such as Carlisle Companies plan-



Source: Haver Analytics



Source: Haver Analytics

ning to bring production back to the U.S. from China. This does not bode well for future expansion of manufacturing industries in Canada. Already there is evidence that businesses are feeling the pinch of producing in Canada, with Caterpillar recently closing a plant in Ontario and moving production to the United States.

Canada's high cost of production is perhaps the most pronounced in the auto sector. Automakers looking to expand capacity or shift production to North America in order to reduce shipping costs and lower foreign exchange exposure are increasingly looking to the U.S. and Mexico rather than Canada because they are more competitive. Case in point, Nissan, Honda and Mazda are investing in Mexico and Volkswagen is planning to open a new plant in either the U.S. or Mexico to build Audi vehicles. Meanwhile, Ford just closed a plant in Canada. In 2011, Canada's share of total North American production fell to 15.8%, marking the lowest level since 2003. Prospects for an improvement in that ratio are not great. Canada's production mix is heavily skewed towards larger vehicles because it is unable to profitably produce smaller vehicles. With a large chunk of new investment likely to stem from the subcompact segment in the coming years, given that it is the fastest growing segment on the continent, Canada is likely to be left behind.

Labour negotiations in Canada between the union and the Detroit Three automakers are set to take place later this year. Similar negotiations in the U.S. led to a two-tier wage structure – a tactic that is becoming more common in generating cost savings by employers. Media reports suggest that the CAW is not supportive of such a strategy.

Invest or shrink

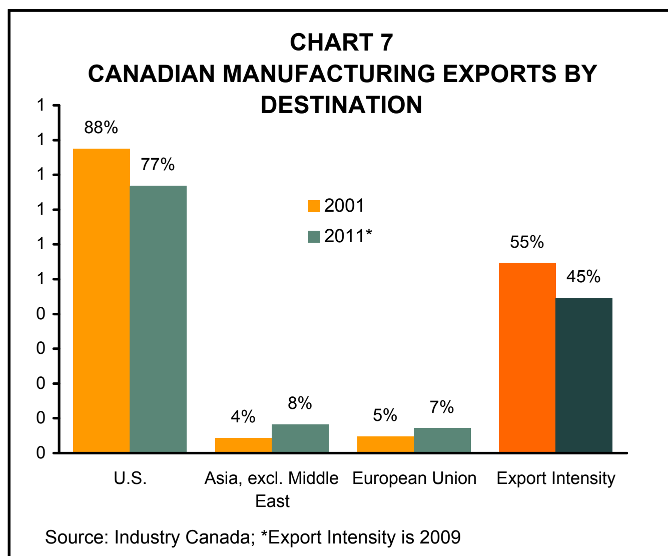
As such, Canada needs to step up its game – not only to attract new investment, but also to keep the manufacturing base that currently exists. While cost cutting will certainly help, businesses are also going to have to become more capital intensive. Profits for manufacturers bounced back quite strongly in the fourth quarter of 2011 following two quarters of declines, and we expect profits to continue to grow going forward. As well, businesses are sitting on elevated cash levels, which they can deploy once the timing is right. According to a recent survey by Statistics Canada, manufacturers intend to increase investment spending by 6.6% in 2012, which would mark the highest level since 2000. Investing in machinery and equipment (M&E) would be a good place to start – especially given the weak performance of Canadian businesses relative to their U.S.

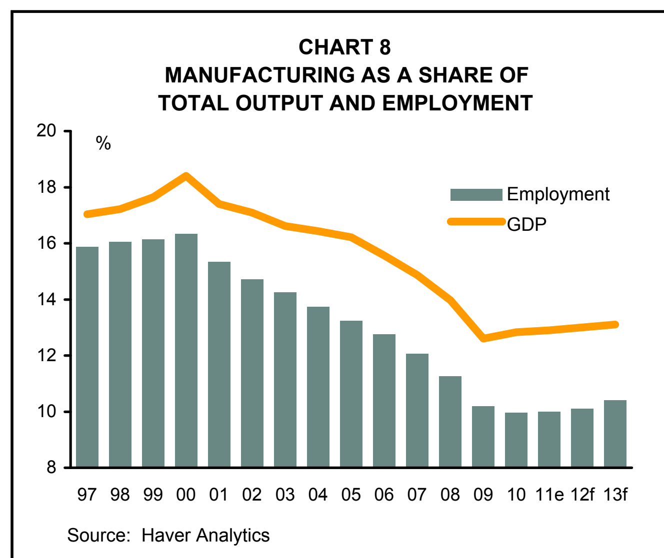
counterparts over the past 20 years. Indeed, as shown in Chart 6, M&E investment by the business sector in Canada has been well below that in the U.S., which partly explains the productivity gap. And now is an especially good time to invest since interest rates are low and the loonie is strong (a large portion of M&E is imported). Investing in research and development, as well as skills training, would also help to increase productivity and bring down unit labour costs.

Export diversification a work in progress

Manufacturers can also improve their business position by diversifying their consumer base. While the U.S. will always be an important market for Canadian-made goods given its proximity and size, reliance on a single market can be problematic – especially when that market is expected to grow at a modest pace at best over the next few years. Moreover, the U.S. has actively been seeking to establish free trade agreements with countries around the world, suggesting that Canada will be facing some hefty competition as more nations obtain access to the U.S. market that Canada has had for some time now.

Accordingly, Canadian producers should work on tapping other growing markets so they are not so dependent on one economy. Some progress has been made over the past decade (see Chart 7). In 2001, roughly 88% of all manufacturing exports were sent to the U.S. Since then, Canada has diversified its export portfolio, as America accounted for only 77% of manufactured exports in 2011. Asia and the European Union have picked up a large chunk of the difference. In particular, exports to China have risen by over 150% during the last decade. Moreover, while a larger





share of Canadian-made goods is landing overseas, a larger portion is also being sold domestically. Indeed, in 2009, only 45% of all manufactured goods were exported – a 10 percentage point drop from 2000.

While Canadian manufacturers' reliance on the U.S. has diminished somewhat over the past 10 years, further diversification would be beneficial. The federal government has been working to negotiate free trade agreements with several countries around the world – including one with the European Union which should be finalized this year – which will aid in the transition to a more diverse export base. While there can be winners and losers, research shows that trade agreements deliver a benefit to both countries in terms of increased productivity – an added bonus for manufacturers.

Limited help expected from the government

Governments can help support the sector in other ways as well, as they have over the past few years. The federal government has reduced the corporate income tax rate from 21% in 2008 to 15% in 2012. In Ontario, the capital tax was eliminated, which has also benefited the province's manufacturing sector. However, with elevated debt levels, governments at all levels will be focused on shoring up their balance sheets, so any meaningful support may be hard to come by in the near term. In fact, while the corporate income tax rate in Canada is considerably lower than in the U.S. (35%), this advantage is not a sure thing going forward. Indeed, the U.S. government is considering reducing its corporate income tax rate, while some provinces in Canada are contemplating increasing them.

Competitiveness to make or break the sector

The bottom line is that the Canadian manufacturing sector is under a great deal of competitive pressure, and must invest in innovative practices and technologies that will help boost productivity and lower unit labour costs. Overall, we expect the sector to continue to bounce back from the cyclical downturn, with the machinery and auto and parts sectors continuing to record healthy gains, along with the computer and equipment industry. However, the pace of growth will be limited. We expect manufacturing output to grow by 3-4% this year and next, suggesting that the sector's share of total output is not likely to exceed the pre-recession rate of 14% in the foreseeable future, let alone return to the 18% seen a decade ago. This doesn't bode well for employment in the sector, as it will not likely rebound to the levels seen prior to the recession. Still, given that manufacturing job gains have been scarce during the recovery thus far, we expect the sector to contribute to employment growth over the next couple of years as manufacturers become more comfortable expanding and hiring in the economic environment. As a share of total employment, factory jobs will likely make up 10-11% of the national total over the forecast horizon.

Dina Cover, Economist
416-982-2555

References

[1]Terence Corcoran: Labour loses its advantage. http://opinion.financialpost.com/2012/02/08/terence-corcoran-labour-loses-its-advantage/

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