



TD Economics

Special Report

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BIG WHEELS KEEP ON TURNING: GLOBALIZATION & THE HEALTH OF THE CANADIAN AUTO INDUSTRY

There has been considerable attention given to the trials and tribulations of the Canadian auto sector in recent years. Often one reads about how the Canadian automobile industry has suffered from globalization. There has also been widespread talk about the industry being in crisis. However, these perceptions are often presented in a black and white manner, when the reality is far greyer.

While globalization is having a big impact on the auto sector, the trends and influences are very different from those experienced by many other industries. Indeed, one can argue that the North American auto market is still a relatively, and surprisingly, closed marketplace.

Moreover, the recent performance of the Canadian auto sector does not support the perspective that there is an industry-wide crisis. Quite to the contrary, the Canadian auto industry has been performing reasonably well, despite a wide array of challenges. However, this overall assessment masks the well publicized divergent trends between the Big Three domestic assemblers (General Motors, Ford and DaimlerChrysler) and the Big Three Japanese assemblers (Toyota, Honda and Nissan), with structural problems created in part by high legacy costs at the former and remarkable vitality at the latter.

This paper will review these issues in turn, discussing the influence of globalization on the auto sector, the recent performance of the overall Canadian auto industry and the challenges facing the domestic assemblers. The analysis will attempt to dispel a few popular myths, while still acknowledging the fundamental reality that the North American Big Three, as well as the domestic parts producers that are heavily leveraged to them, are facing very difficult times.

AUTOMOTIVE SALES AND PRODUCTION					
	Thous. of units 2005	Per cent change			
		2004	2005	2006F	2007F
SALES OF LIGHT VEHICLES					
NORTH AMERICA	19,657	1.5	0.9	-2.0	-1.5
Canada	1,583	-3.7	3.2	-0.5	-1.2
United States	16,948	1.4	0.5	-2.0	-1.8
Mexico	1,126	12.0	3.3	-3.4	2.5
PRODUCTION OF LIGHT VEHICLES					
NORTH AMERICA	15,752	-0.8	0.0	-1.3	-1.2
Canada	2,624	5.7	-1.5	-3.2	-2.2
United States	11,523	-1.9	-0.7	-1.6	-1.3
Mexico	1,605	-2.4	7.8	4.1	1.0

Forecast by TD Economics as at May, 2006
Source: DesRosiers Automotive Reports, Ward's, TD Economics

Globalization has not created an open auto market in North America

There is a widespread perception that the auto industry has become 'globalized', and in many respects this is true. The largest companies are based in a variety of different countries and production is increasingly located throughout the world. But globalization is also usually understood to involve rapidly growing international trade flows, so that there is typically a declining share of domestic sales served through locally-based production. This has not occurred in the auto industry.

Instead, production has been shifting toward where the sales are made. This pattern of globalization is no doubt occurring because of high transportation costs and the fact that many of the growing markets have low labour costs, making them attractive production sites. This can be il-

illustrated by the rapid growth of the auto sector in China. Meanwhile in North America, the threat of possible trade protectionism in response to large imports of vehicles and parts, as well as “moral suasion”, may have also been factors that encouraged overseas auto producers to invest in plants within the United States, Canada and Mexico.

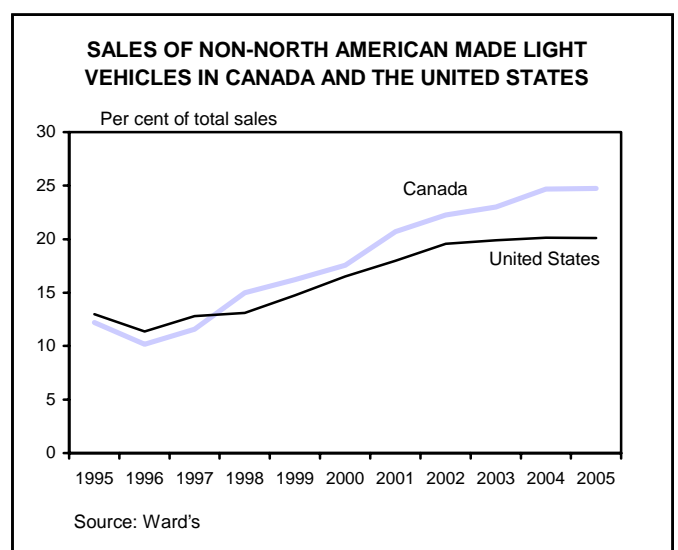
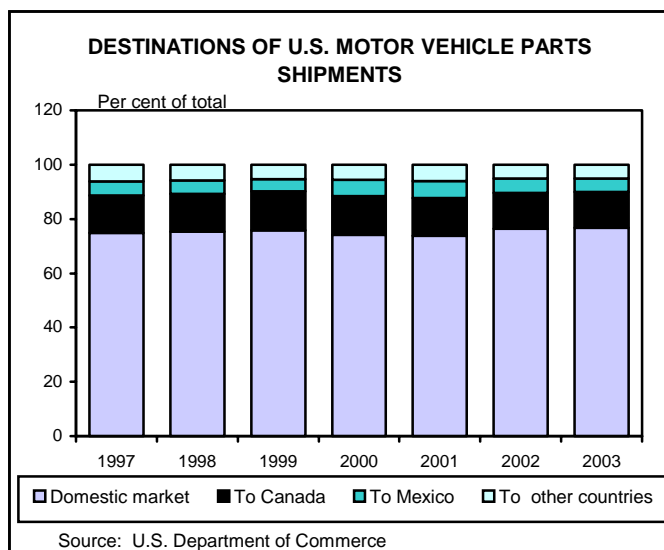
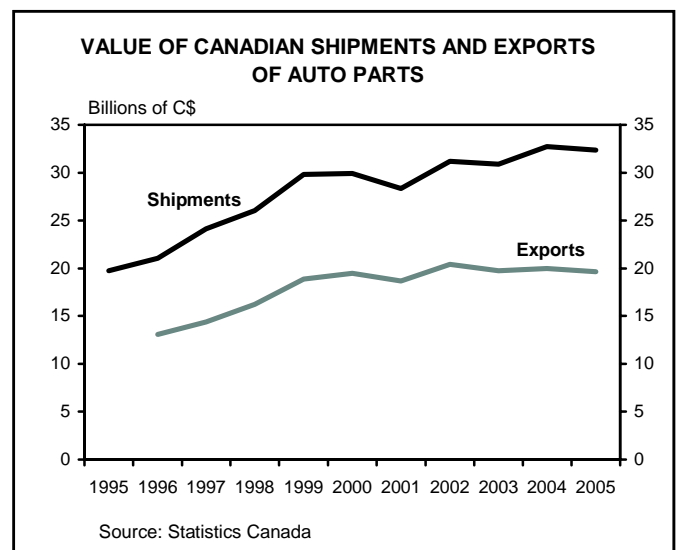
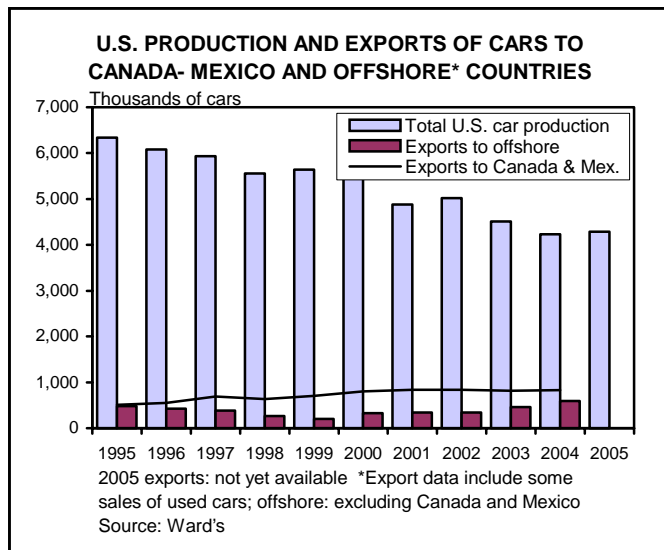
Vehicle exports from North America are limited

As a result, North America is still a relatively closed market from the perspective of intercontinental automotive exports. We do not have data on unit exports of automobiles from Canada to markets other than the United States, but the export figures from U.S. production are probably indicative of what takes place in Canada as well. The United States usually exports less than 10% of its pro-

duction of automobiles to offshore markets. Exports of motor vehicle parts to overseas are even less important at 5-6% of U.S. production. Canada exports almost two-thirds of the parts it produces, with about 60 per cent of production going to the United States, about 3% going overseas and 1% to Mexico.

Greater exposure to imports, but less than in the past

The North American automobile market is more open to the world from the import side, but not as much as one might think and surprisingly less so than a few decades ago. Vehicles produced by companies other than the North American Big 3 currently account for about 44% of North American sales. However, many of the major foreign automobile companies now provide the bulk of their North



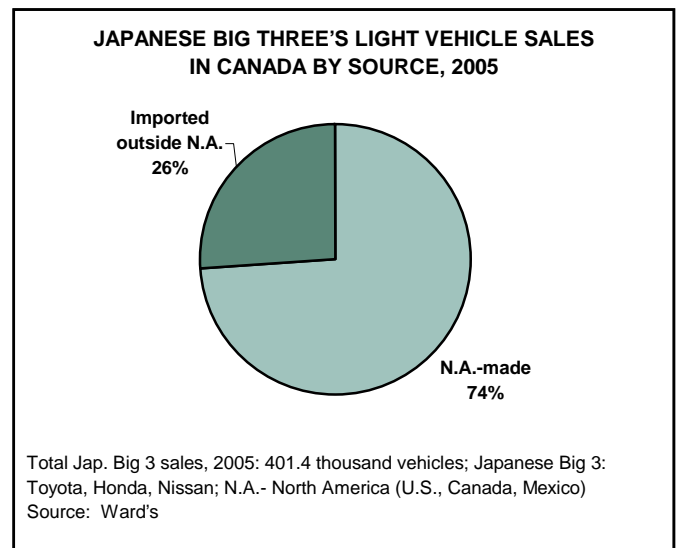
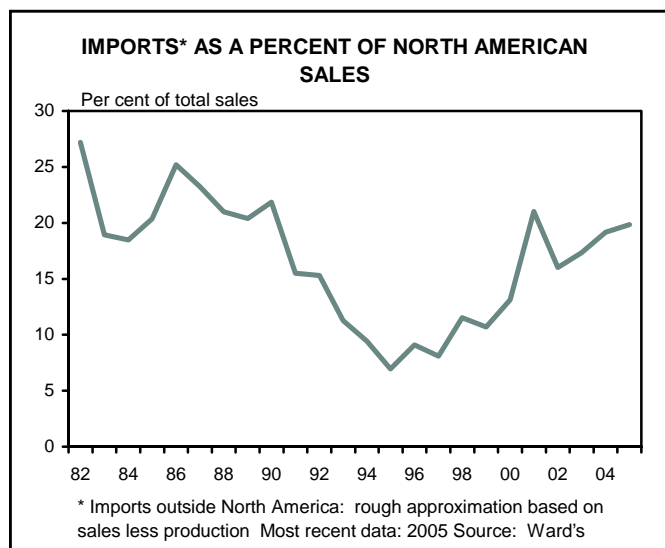
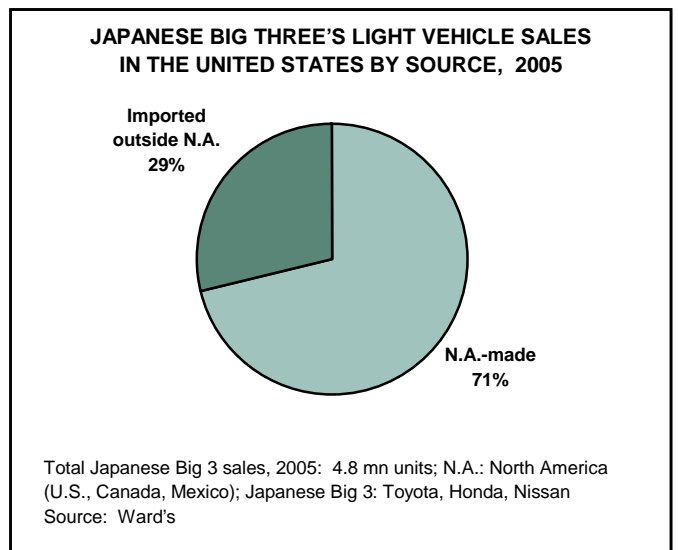
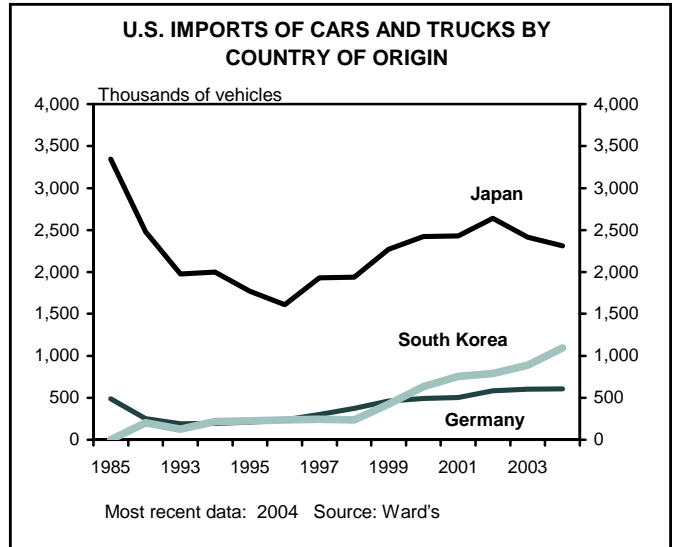
American sales from their production facilities on this continent. As a result, imports account for only 20% of sales of light vehicles in the United States and just under 25% in Canada.

Moreover, the import share has declined from its level in the early 1980s. Imports were 27% of sales in 1982. They fell to below 10% in the mid-90s, before rebounding to 20% in 2005. This cycle reflected the impact of Japanese assemblers increasingly satisfying North American demand through production at plants in North America. The recovery in the import share since the mid-90s occurred as the Japanese plants ran into capacity constraints in North American production and in response to increased imports from South Korea, and to a lesser extent, Germany.

In Canada, the recent import penetration has doubled in just 10 years, while it has almost doubled in the United States. Toyota, Honda and Nissan in aggregate supply 29% and 26% of their sales in the United States and Canada, respectively, through imports, with the remainder being met through North American production. However, this is a considerable decline from the share in 1990, when these Japanese companies used imports to satisfy 58% and 70% of their U.S. and Canadian sales, respectively. Honda in particular meets the vast majority of their U.S. and Canadian sales through production on this continent.

Auto parts more open to trade

U.S. imports of motor vehicle parts are quite diversified with about 50% coming from overseas markets. At



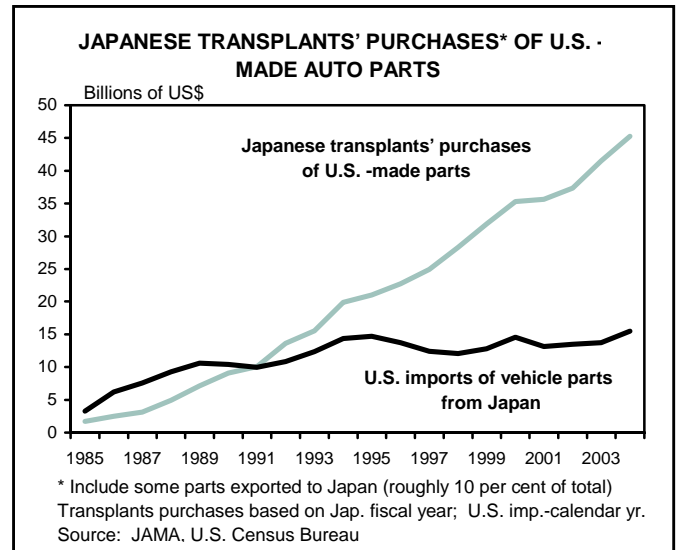
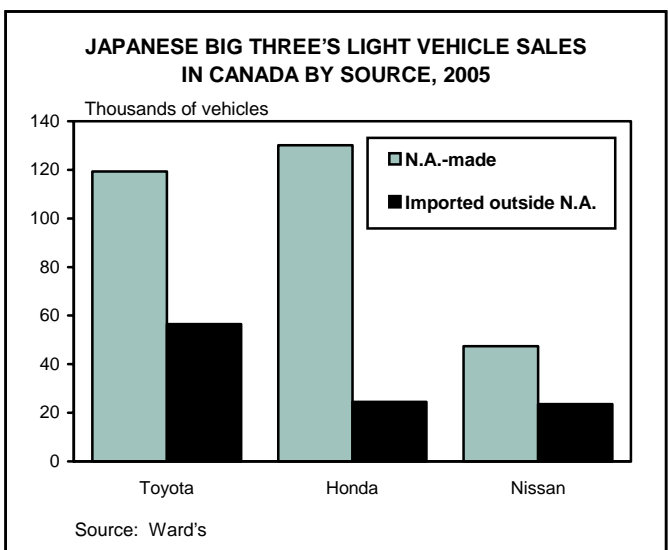
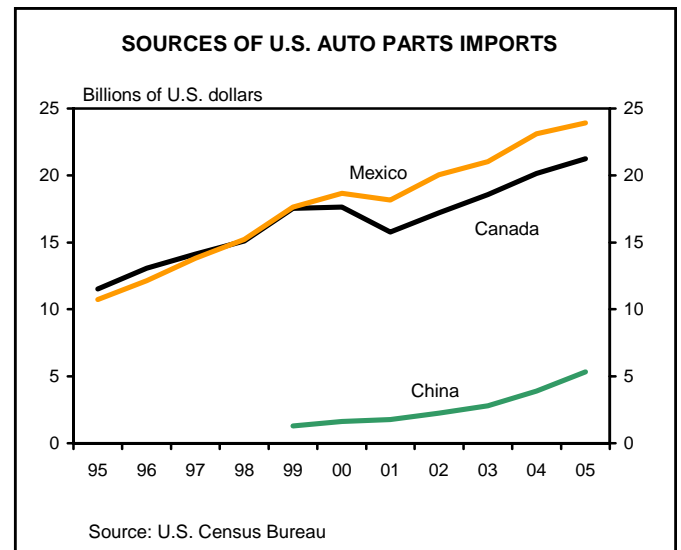
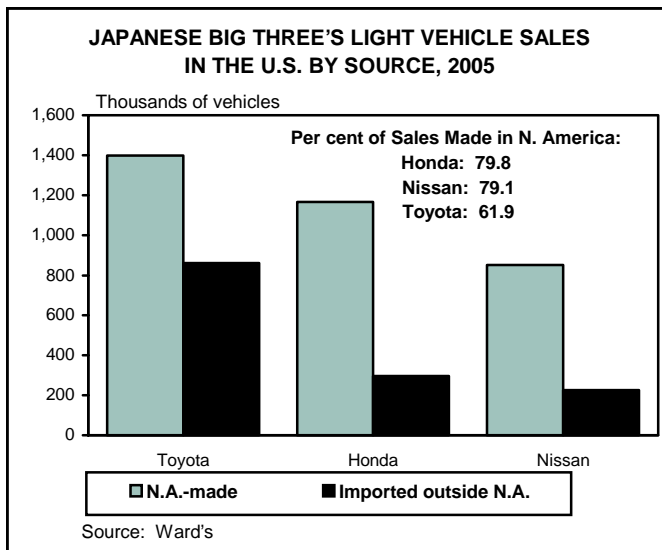
the end of the 1990s, Mexico surpassed Canada as a supplier of parts to the U.S. market. U.S. parts imports from China have just recently become important, and they are growing rapidly. U.S. imports of car parts from Japan have been flat, while the purchases of U.S.-made parts by the Japanese “transplants” has soared, reflecting the fact that Japanese suppliers followed the Japanese assemblers in setting up operations in North America. Canada imports parts almost exclusively from the United States, although one should recognize that some of these parts may be originating overseas, but are landing first in the U.S. before being shipped to Canada.

So, the main conclusion is that globalization is not having its traditional impact of acting as a catalyst for greater imports and exports of auto products. Instead, the reduc-

tion to the barriers of trade has seen greater foreign direct investment into auto and auto-related production within North America. This is clearly beneficial from an overall employment perspective, but it has created significant competitive challenges for the domestic auto assemblers and the domestic parts industry that tends to be more heavily leveraged to the Big Three. Before discussing these hurdles, let’s take a moment to review the condition of the overall Canadian auto industry.

The Canadian automobile industry has been performing reasonably well

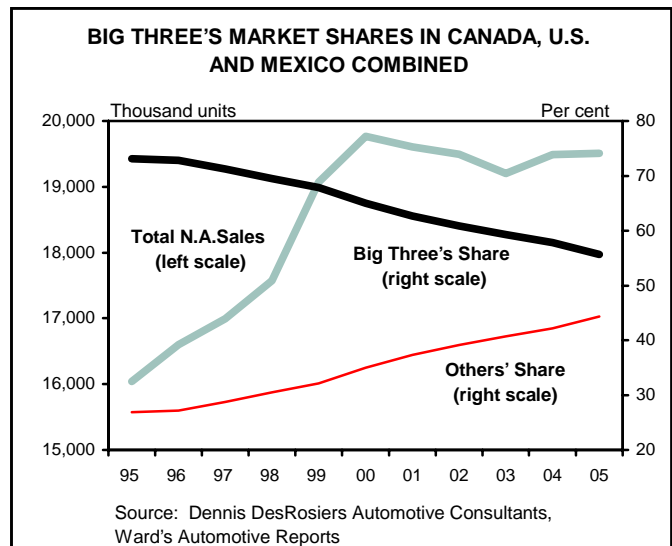
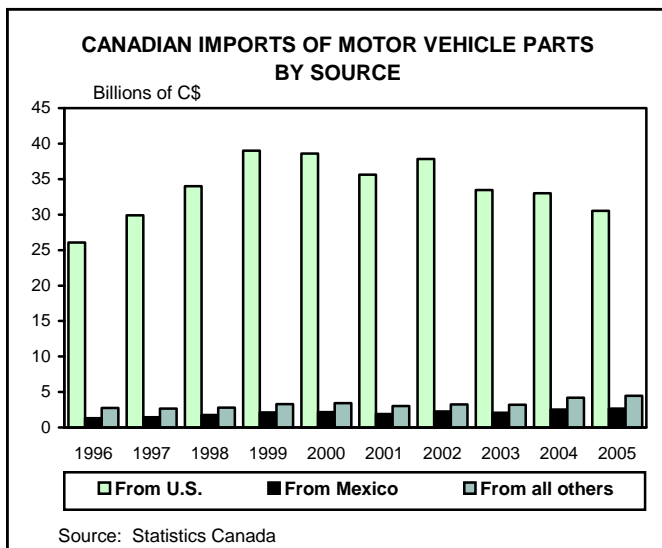
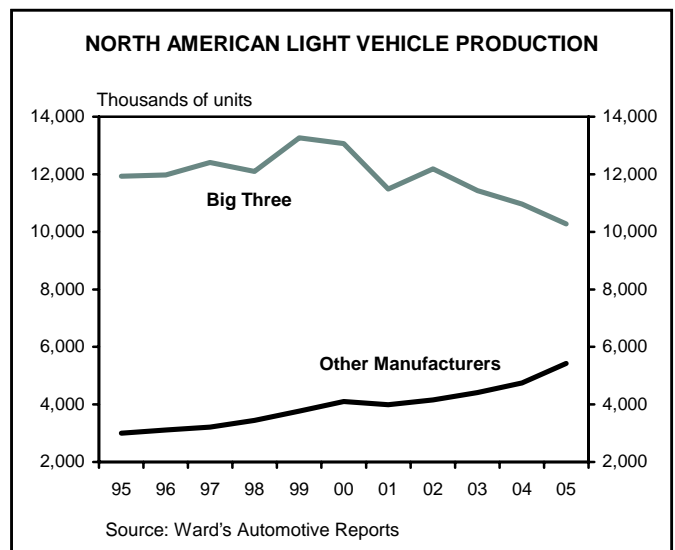
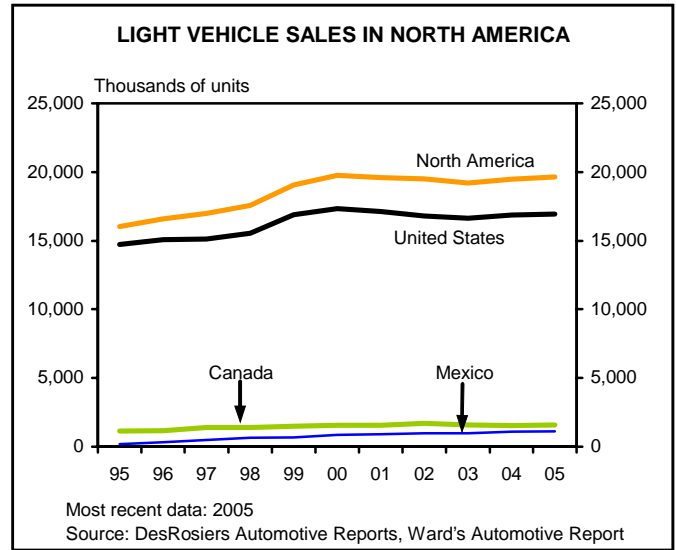
It is conventional wisdom that the North American automobile industry is suffering badly as of late. Indeed, the word ‘crisis’ is often used to describe economic condi-



tions. But, this perspective is not supported by the figures for total light vehicle production, which have been relatively flat over the past 10 years in Canada and the United States and on an upward trend in Mexico. Overall, total North American auto production has floated at slightly above the 15 million unit mark over the past decade, which is a relatively high level of activity. It is true, however, that production by the Big Three North American producers has been on a declining trend since its peak in 1999, with production of other manufacturers (the so-called transplants) steadily trending upwards. Canada's share of North American production of light vehicles has held fairly steady at around 16%, while Mexico's has risen from 6 to 10% in the past decade, implying a slight erosion in the U.S. share.

The story for sales is very similar. Total vehicle purchases have been relatively flat. However, the share held by the Big Three North American assemblers has slipped even more for sales than for production, dropping to 56% last year, implying a perfectly symmetrical rise in the market share going to foreign producers.

The distinction in production trends between the Big Three North American producers and the foreign companies is also apparent in capacity utilization rates for North American production. General Motors, Ford and DaimlerChrysler are together operating at just over 80% of their North American capacity, while the Japanese companies are running flat out. Breaking it down by company, Ford's capacity utilization rate is particularly low and Toyota is running well over 100% capacity due to heavy use of overtime.

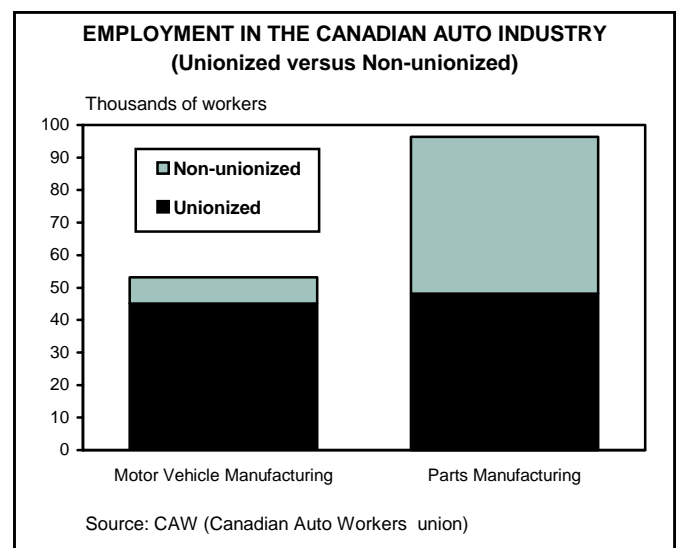
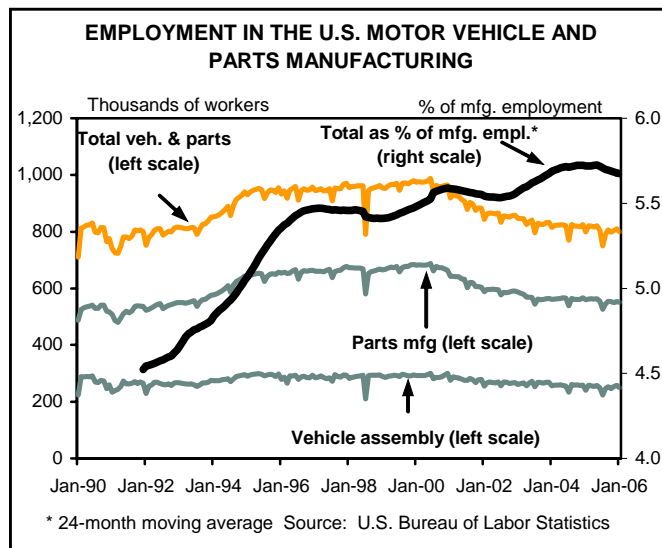
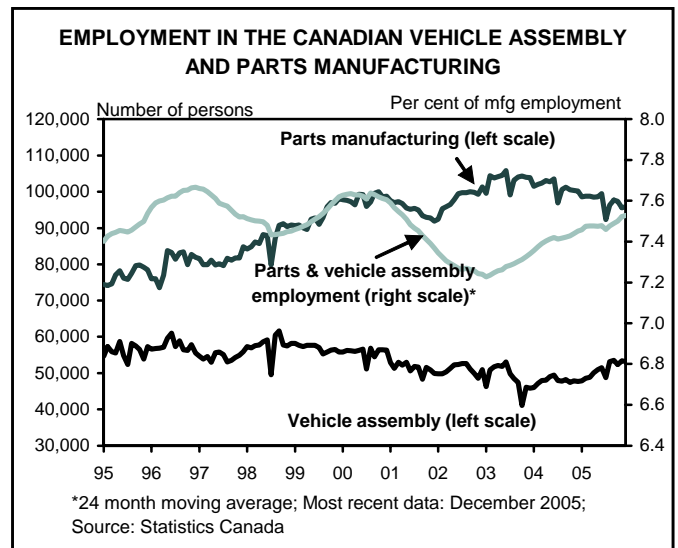
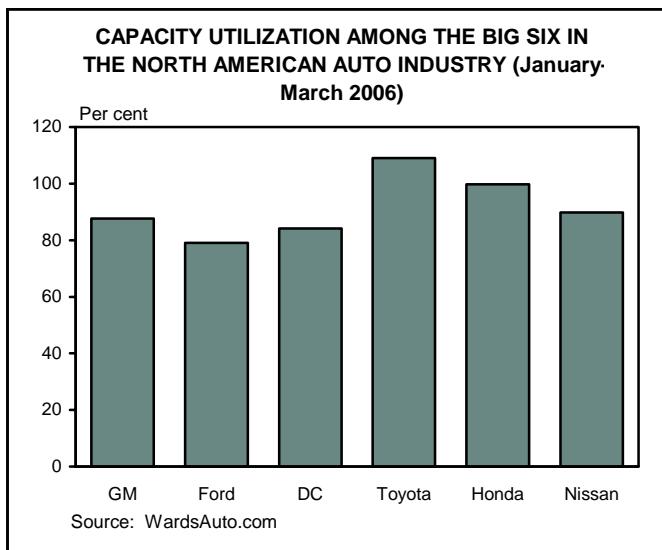


The demise of the North American automobile industry is also not apparent in the employment statistics. Employment in U.S. vehicle assembly has been flat, while employment has declined in parts manufacturing. In total then, employment is down in the U.S. automobile industry. However, the job cuts have been less than in other manufacturing industries, with the surprising result that the auto industry accounts for a larger share of total U.S. manufacturing employment than previously.

In Canada, employment in vehicle assembly has come down from the 1990s, but has been fairly flat over the past 5 years. Employment in parts trended sharply upward over the second half of the 1990s and has also been quite flat so far this decade. Assembly and parts together employ more people today than 10 years ago, but the level of employ-

ment has stagnated recently. Employment in both segments of the Canadian industry has accounted for around 7.5% of total manufacturing employment over the past 10 years. Unionization in the Canadian automobile industry has declined, largely reflecting the fact that the growth in jobs has come from the parts side, where unionization is much less prevalent than in motor vehicle manufacturing.

The Canadian automotive industry also appears healthy from the perspective of capital investments, which are at an all-time high by a large margin, thanks to a number of recent expansions announced by both North American and Japanese companies. For example, Ford will invest \$1 billion on its Oakville facility, GM will invest \$2.5 billion on its Beacon Hill project, DaimlerChrysler has announced \$768 million in upgrades in Windsor and Brampton, Toyota



plans a new assembly plant in Woodstock, Linmar intends to invest \$1.1 billion in the coming years on its parts business and Honda has just recently announced that it will build an engine plant near Alliston.

There is no shortage of challenges facing the North American Big Three

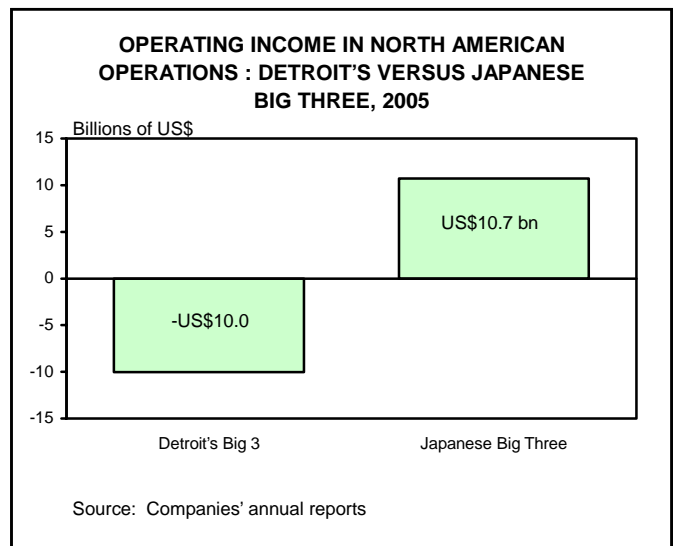
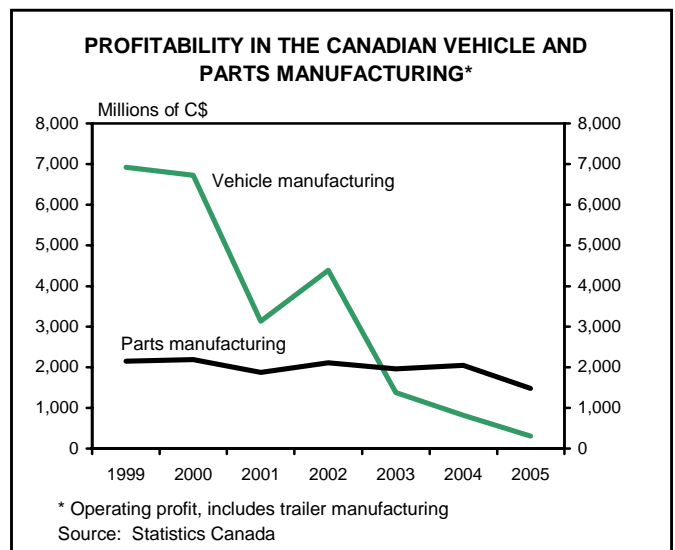
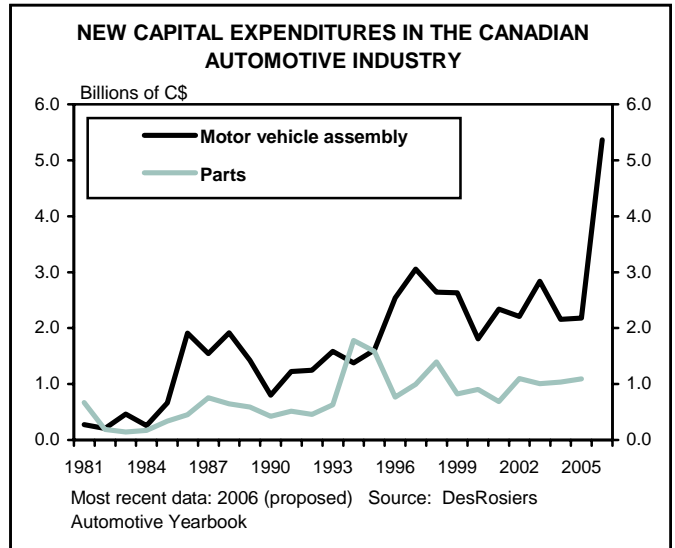
So, the assessment of the Canadian auto industry has a glass half-empty or glass half-full dimension. In aggregate, the sector is not in decline, but it is very clear that the North American Big Three are under intense pressure, which creates cascading pressures on their suppliers.

At the root of the problem is the declining market share of the North American Big Three companies. Given the stagnant level of overall sales, the declining market share means that the domestic assemblers have been ending up with excess capacity that requires cost reductions and downsizing. Moreover, the fierce competition in the North American market place and the fight for market share, which has prompted the use of very generous incentives, have taken a powerful toll on profitability.

On the whole, the Canadian auto sector was still operating with a profit in 2005. However, the financial fortunes of the vehicle manufacturing segment deteriorated rapidly, with the operating profit plummeting from nearly C\$7 billion in 1999 to less than half a billion in 2005. The parts segment did comparatively better, with operating income remaining close to the C\$2 billion mark from 1999 to 2004, before dropping to C\$1.5 billion in 2005.

There was, of course, sharply divergent performance between the domestic and the foreign assemblers. Considering the results of their North American operations alone, the Japanese Big Three enjoyed an operating income of US\$10.7 billion in 2005, while the Detroit Big Three, as a group, posted a US\$10.0 billion loss. The latter was essentially due to the heavy losses of GM and Ford, as DaimlerChrysler had an operating income of US\$0.6 billion last year.

Adding to the challenges, there is the consolidation in the parts industry, which has seen the number of firms in the North American automotive supply chain dwindle from 30,000 to 8,000 over the past 15 years. The Original Equipment Suppliers Association projects there will be only 5,000 firms standing at the end of the decade. This does not, of course, signify declining production or necessarily

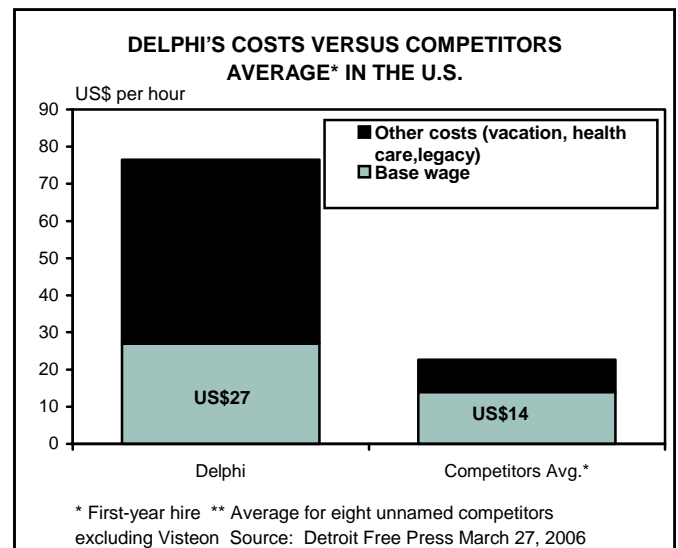
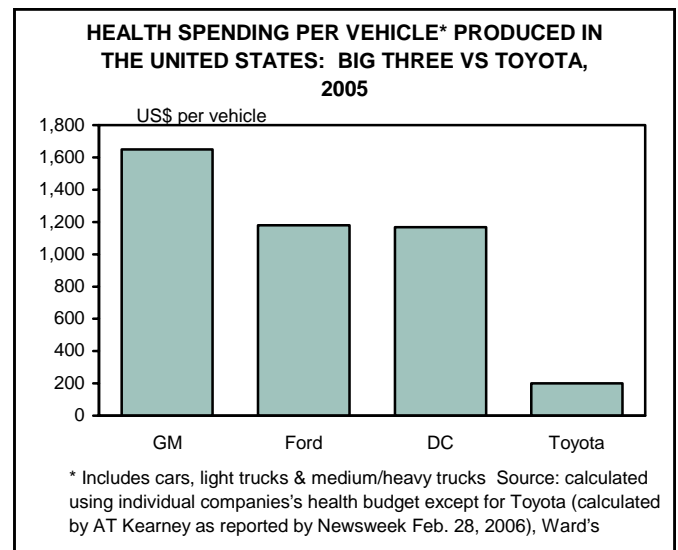
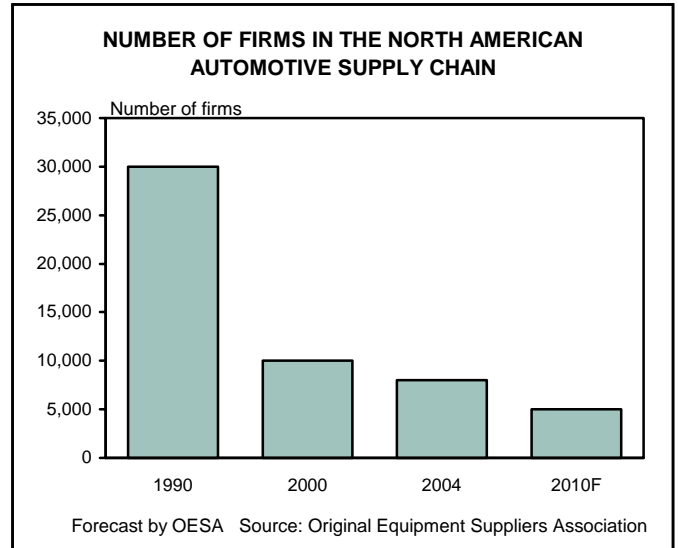


even widespread bankruptcies. Rather, there is a process of integration occurring where the larger, more diversified companies are acquiring the smaller players. Ultimately this should improve the competitiveness and stability of the sector.

Another challenge is the cost structure of the more established companies on both the assembly and parts sides. However, wages and benefits are not a major issue. For example, in the United States, the hourly pay at Toyota and Honda is about \$24, while it is around \$27 for the Big Three North American companies (all references to dollars are in U.S. dollars unless otherwise specified). Furthermore, the Japanese companies pay larger bonuses (the average Christmas bonus last year was \$10,130 for a Toyota worker in Kentucky and \$4,923 for a Honda worker in Ohio, while no bonuses were paid by GM or Ford) and Toyota in Kentucky, as an example, provides 24-hour childcare, an on-site pharmacy and big-name entertainment at an annual banquet.

Instead, the Big Three North American companies' cost disadvantage lies in their legacy costs because they have many more retirees than the transplants with their younger workforce. According to Dave Cole of the Center for Automotive Research, GM spends about \$2500 per vehicle more than Toyota. Half of the \$2500 disadvantage stems from the cost of retirement benefits. In 2003, 72% of the participants in GM's pension plan for hourly-rate employees were retirees. Thanks to a 13% rate of return in 2005, General Motor's pension plan had a \$6 billion surplus at the end of last year. However, Ford's worldwide pension obligations were underfunded by \$10.8 billion. This is close to the entire market value of the company. In contrast, Toyota has almost no retirees. The situation will change over time, however. For example, Honda is now retiring about 100 workers per month.

Healthcare costs are another distinguishing feature between the Big Three North American companies and the transplants. Because the Big Three North American companies have many more retirees than the transplants, their health spending relative to their vehicle production is significantly higher than, say, Toyota. At the end of 2004, General Motors had unfunded post-retirement medical liabilities in excess of \$61 billion. At the end of last year, Ford's unfunded post-retirement medical liabilities were \$32.8 billion.

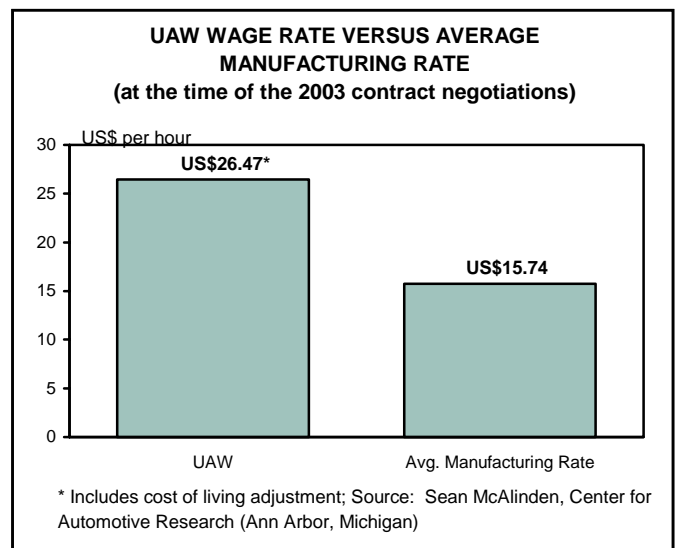
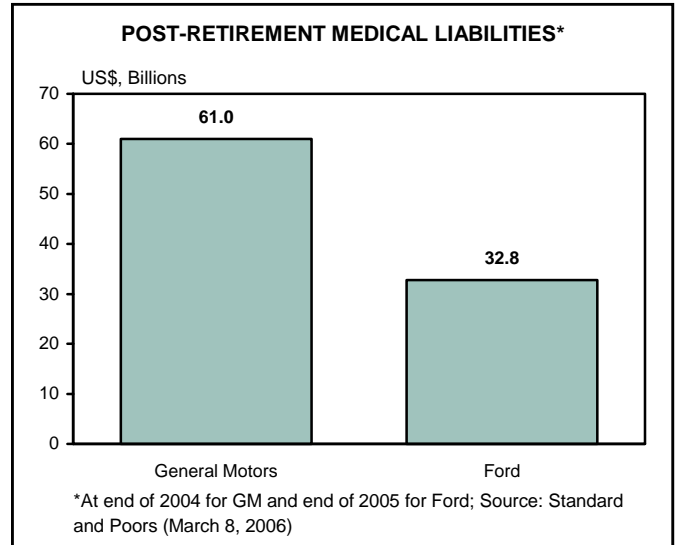


The health deal reached by General Motors with the United Auto Workers last October and approved recently by the court will ease some of GM's financial burdens. The deal requires: (i) hourly retirees to pay deductibles, premiums and co-insurance costs for the first time; (ii) active hourly workers to contribute part of their future pay increases to a new fund to help pay for retirement coverage.

GM has said that the agreement would save it \$1 billion after taxes each year and would shave \$15 billion off its \$70 billion in long-term retiree health care liabilities. There is a similar agreement with Ford and a judge will consider objections from Ford retirees at a hearing on May 31st. DaimlerChrysler is seeking a similar deal with the United Auto Workers.

The outcome of current developments at the auto parts giant Delphi may have ramifications throughout the industry. Delphi workers currently receive an average of \$26.97 an hour, but with benefits included, the cost to the company is \$76.46. The average all-inclusive cost of U.S. competitors is only \$22.70, given that wages are lower, and more particularly, benefits are a mere fraction of what the Delphi workers receive. Delphi is under bankruptcy protection and originally proposed slashing average wages to \$12.50 an hour and bringing the total compensation cost down to \$36.47. On March 31st, Delphi bumped the wage offer to \$22 an hour until September 3, 2007, after which it would be reduced to \$16.50 an hour. That offer carries a bonus of a \$50,000 "wage buydown". Delphi, the United Auto Workers and General Motors are continuing their negotiations. Most analysts believe that a deal will be reached, since it is in no one's interest to go through a crippling strike.

The Delphi case provides another illustration how the automobile industry does not fit into the typical mold of globalization. In this case the competitiveness pressures are not so much with the low wages in developing economies like China, but rather with the non-unionized work force located in North America. Broadening the analysis somewhat, the average base wage of members of the United Auto Workers was \$26.47 just before the 2003 contract negotiations compared to \$15.74 for all U.S. manufacturing workers.



Tectonic changes underway, but will take some time

Looking ahead, many of the above mentioned trends are likely to persist. In contrast to the traditional perspectives of globalization, the outlook is for auto production to continue to shift towards assembly in foreign markets to satisfy sales in those markets. For example, China will see explosive growth in auto sales and production in the years ahead. In North America, the dominant theme will continue to be fierce competition amongst the assemblers for market share, which will keep profitability under pressure. It is expected to remain a buyers market, where new vehicle prices rise at only a modest pace and companies strive to introduce ever greater improvements in quality.

The Big Three domestic producers are in the process of changing their business models, with GM and Ford being forced to make the largest alterations in their costs and processes, and these efforts will take some time to complete. The possibility that a domestic auto producer is forced into bankruptcy protection cannot be ruled out, and if one goes the others are likely to follow in order to maintain a level playing field. However, it doesn't have to turn out that way.

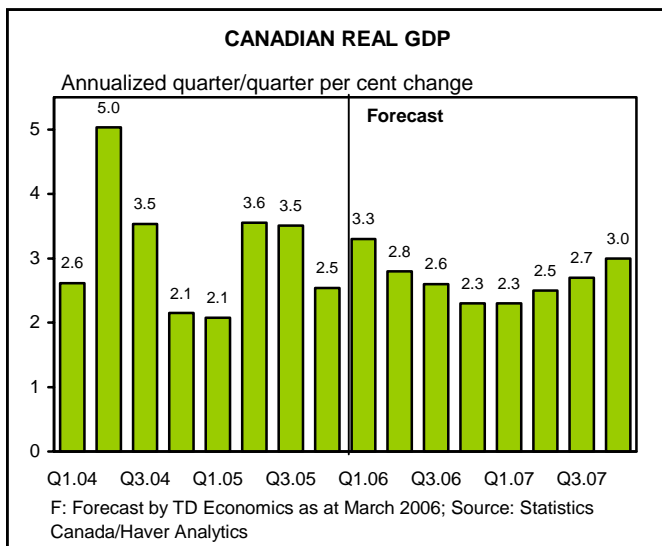
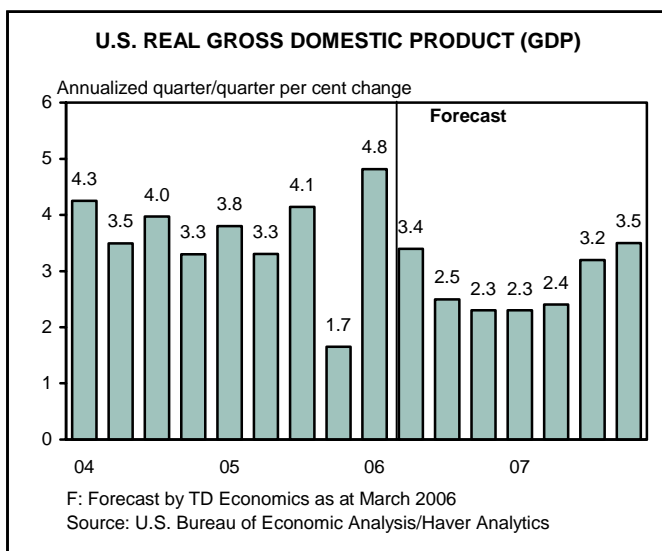
In the near term, the foreign assemblers will continue to post good sales, solid profits and rising market share. However, if the North American Big Three are successful in their restructuring, the tide will shift or at least stabilize.

In terms of the overall market, sales will be supported by rising personal income and low unemployment. However, sales will be constrained by the diminishing impact of the previously introduced incentives. Auto purchases may also be dampened by a slowdown in the U.S. economy. There are clear signs that U.S. housing markets are starting to cool, and given the considerable wealth effects created by booming housing markets in recent years, this is likely to lead to significantly slower growth in consumer spending. Indeed, reduced mortgage refinancing and less equity being cashed out from homes is expected to dampen purchases of big-ticket items, like autos. The implication is that light vehicle sales are likely to trend lower in the latter part of 2006 and in early 2007. The weaker performance by the U.S. economy will also impact Canada and Mexico. But, even with the expected pullback in auto sales, the overall level of sales will remain healthy.

So, the state of the Canadian auto industry will be far from booming, but neither will it be a crisis. However, this aggregate perspective will mask changing economic and market conditions for the individual companies.

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