TD Bank Financial Group

TD Economics

Special Report

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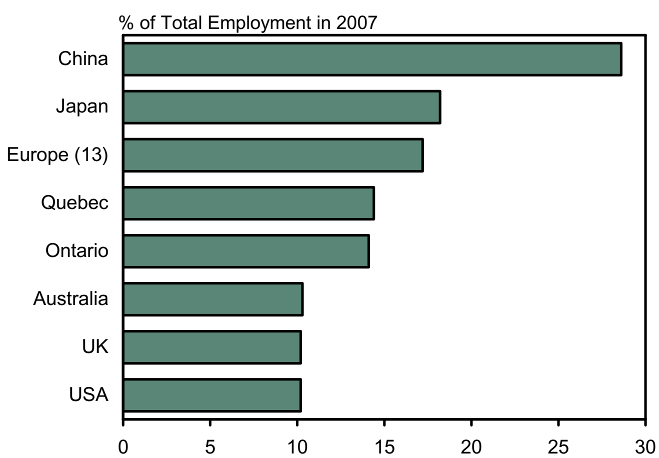
ONTARIO AND QUEBEC'S MANUFACTURING WOES

Much More to the Story than Just the High C$

The economies of Quebec and Ontario share some important commonalities. One in particular is their heavy orientation towards manufacturing, with roughly 20% of total output and one in eight jobs directly generated by the sector. Yet these provinces also face the similar challenge of a manufacturing sector under severe stress. Since reaching a peak in 2000, manufacturing output has been reduced in Ontario and Quebec. And since 2002, job losses have begun to mount, with some 180,000 positions (or roughly one in six of total factory jobs) eliminated in Ontario and some 140,000 (one in five) in Quebec. The hub-city regions of Toronto and Montreal have shouldered about half of these losses, respectively. And, looking ahead, the sector's fortunes are almost certain to deteriorate further. Despite news of a bounceback in factory jobs in central Canada in January, the January 2008 release of Statcan's *Business Conditions Survey* points to further declines in production and employment in the months ahead.

RELATIVE SIZE OF MANUFACTURING



Source: Haver Analytics

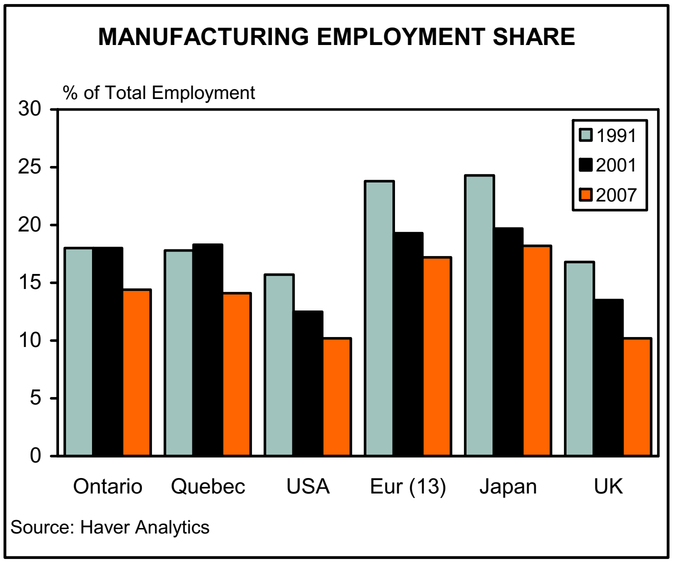
HIGHLIGHTS

- **The prevailing view is that the woes of Canadian manufacturers are due to the high C$**
- **However, currency trends have merely masked the bigger culprit, which is a growing trend in the developed world to compete based on productivity in view of the ascension of low-cost China**
- **Canadian manufacturers had been insulated from this trend by a weak C$ ... until recently**

This note takes a step back to look at some of the underlying drivers of the sector's woes. Much of the blame has been leveled at the Canadian dollar, which has risen steadily from 63-65 US cents at the start of the decade to above parity in late 2007. The dramatic loss in cost competitiveness vis-a-vis the U.S. over the past six years has been a bitter pill to swallow for Canadian producers, especially as they have also contended with rising energy prices and, more recently, a U.S. slowdown. However, a closer look shows that the bigger culprit behind the sector's recent decline is more global in nature and one that is not likely to fade even after the U.S. economy emerges from its funk next year.

Canadian dollar not the only culprit

The proposition that Canadian manufacturing strains are *only* the result of currency developments doesn't stand up to the test. Consider trends in manufacturing across the major industrialized world. Since 2000, factory employment in Ontario and Quebec has fallen on average by 1.4% and 2.0% per year, respectively, which places those jurisdic-



tions behind the United States and the U.K. in terms of manufacturing job losses and in line with Japan (see chart). Yet U.S. producers have benefited from a 24% drop in the value of the greenback on a trade-weighted basis over the period, while the U.K. and Japan have seen their currencies strengthen by less than the loonie against the U.S. dollar.

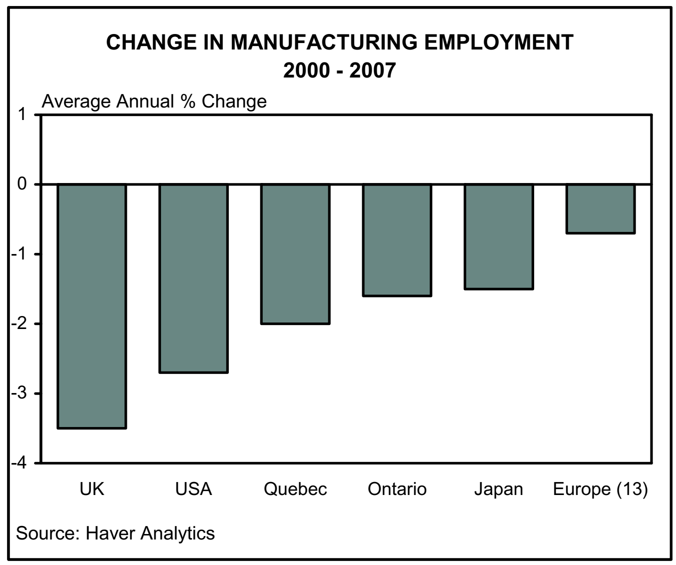
Put another way, regardless of currency trends, Canada is in good company with their advanced-economy counterparts with respect to manufacturing employment reductions. The story boils down to one of survival. Increasing competition from lower-cost Asia, notably China, has been putting significant pressure on manufacturers in the industrialized world to compete based on superior productivity. Producers have responded by increasingly taking advantage of global supply chains, leading to a shift in global manufacturing employment from the advanced to the developing world. In contrast, over the past several years, China has added about 1.5 million workers, or 4-5%, per year to manufacturing payrolls, albeit a rate that has still lagged behind its total employment expansion.

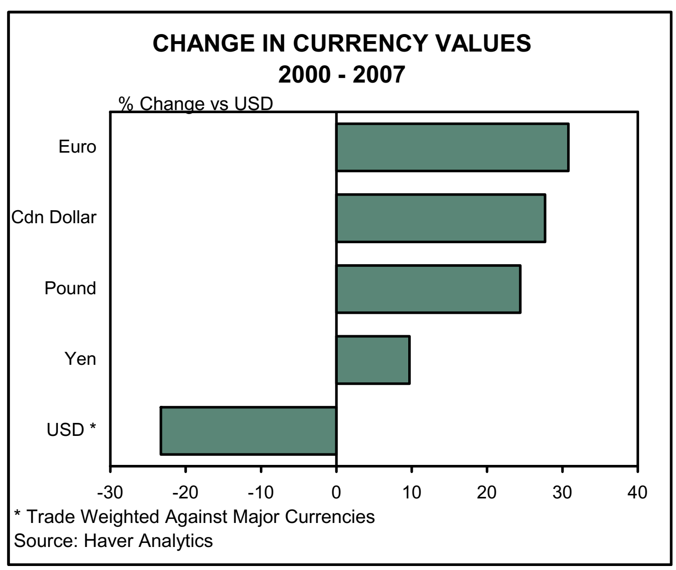
Manufacturing job cuts conceal growing output

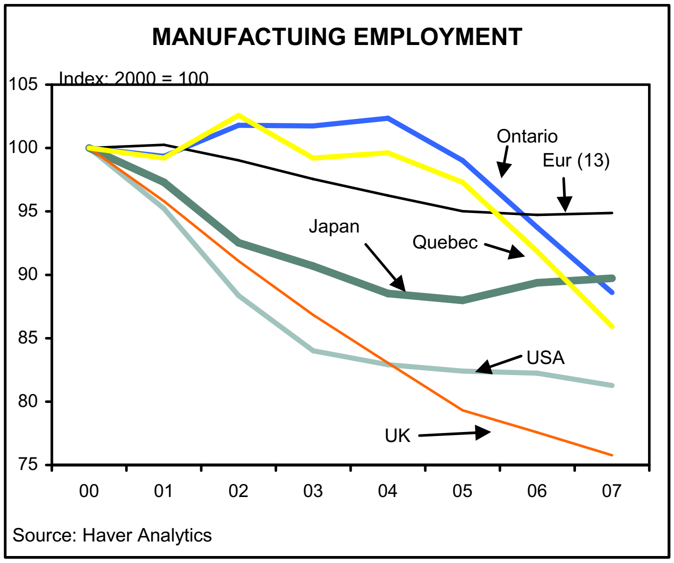
A look back even deeper into the rear-view mirror shows that these global manufacturing trends have actually been in place well before the start of this decade. In some economies (i.e., the U.S., U.K., and France), both the level and share of factory jobs have been shrinking steadily as far back as the 1970s. For others (i.e., Japan and Germany), the peak in manufacturing employment would not occur until the early 1990s. Nonetheless, across these advanced economies, real manufacturing output has not only held up considerably better than the employment side, but has managed to expand over time, hence maintaining the factory sector as a major contributor to overall economic activity and standard of living. The reason for this apparent paradox is success in raising productivity.

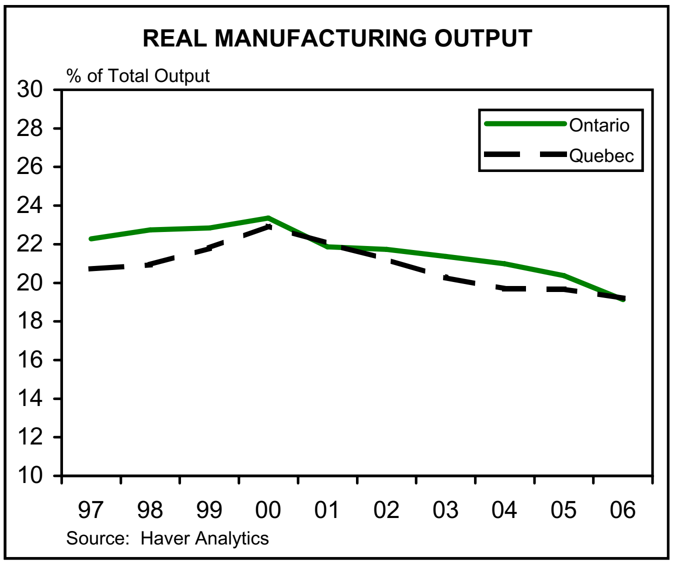
Canadian manufacturing has been insulated

In contrast to other advanced manufacturing sectors, those in Ontario and Quebec have followed a different path, registering rising employment until as recently as five years ago. What explains this divergence in paths with other advanced countries? The signing of NAFTA may provide a partial answer, since that allowed many domestic producers to use their location advantage to penetrate U.S.









markets. The boom in housing and construction across the country, which got underway in the second half of the 1990s, also provided a lift to domestic-oriented manufacturers. But, most importantly, the decline of the Canadian dollar – not just against the U.S. dollar but other global currencies – during the 1990s acted to insulate domestic producers, at least temporarily, to the new competitive realities.

With the currency's flight since 2002, that shield has been gradually chipped away, and now little remains. And with nobody is projecting the loonie to return back to its 1990s levels of 65-75 US cents, Canadian manufacturers have recently begun to make some of the difficult adjustments that their counterparts have been making for years. So far, the results have been mixed. Productivity growth in Canada's manufacturing sector accelerated in 2005 and 2006, thus mitigating the decline in real ouput. Still, gains in output per hour slowed in 2007 and have been running at a lacklustre trend rate of about 1% per year so far this decade. In contrast, real GDP per hour worked in the U.S. manufacturing sector has been advancing by more than 3-4% per year since the start of the decade.

The single biggest weakness in Canadian manufacturing relative to the United States might be under-investment in machinery and equipment. The Canadian dollar's recent strength should have improved the climate for capital investment in Canada, since it has lowered the cost of U.S.-made machinery and equipment. However, manufacturers have been slow to take advantage of the lower M&E price tag even taking into account the recent downward pressure on profit margins.

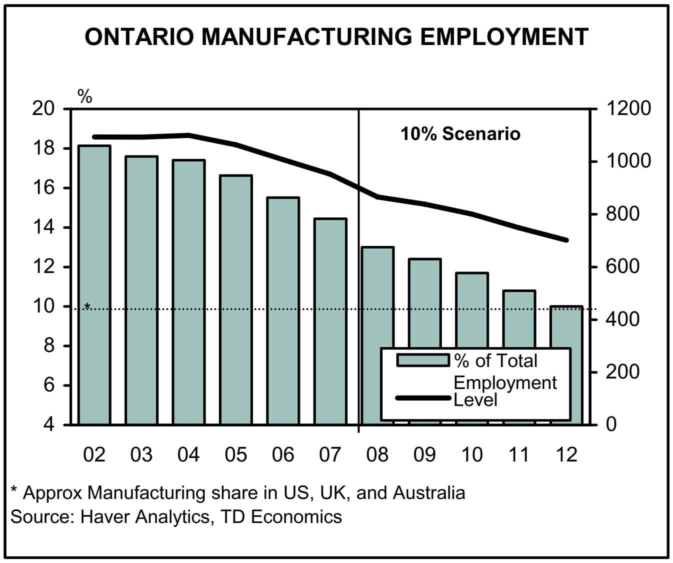
U.S. manufacturers also cutting costs

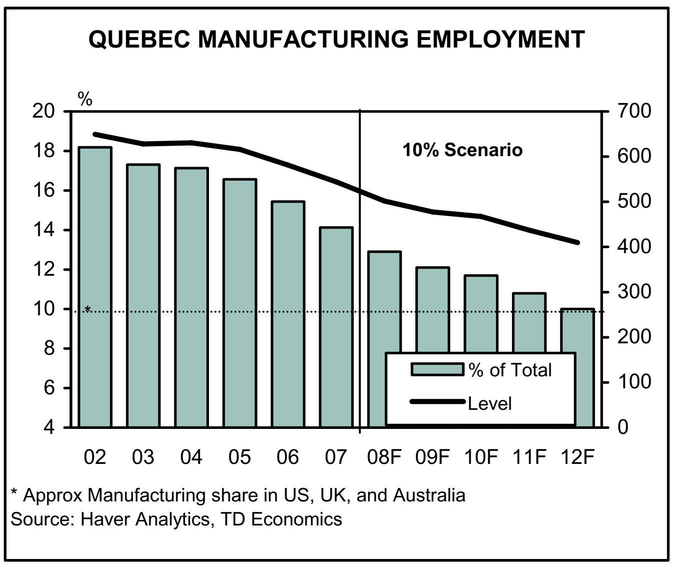
Productivity is fast becoming the watchword in Canada's manufacturing sector, but that is not the only challenge that producers need to be mindful of. In addition to turning in rapid productivity gains and benefitting from a low currency, the U.S. manufacturing sector has also started to shift some of its attention to lowering absolute costs. In the U.S. auto sector, for example, the UAW and the Big Three have reached an agreement which will result in a considerably lower cost structure. The U.S. auto parts producer, Delphi, appears set to exit bankruptcy protection through a deal that will pay employees about US$16-17 per hour or less than half of the rate when the company was still part of General Motors. There are numerous other examples.

How low could employment go?

In light of all of these structural forces at play, it appears that it will not be business as usual for Canadian manufacturing even once the U.S. economy emerges from its doldrums. Manufacturing employment will probably continue to fall under downward pressure. These job cuts will be painful, but to the extent to which producers reap productivity gains, manufacturing output would be cushioned in the short run and jobs and wages in the sector would prove stronger over the longer haul.

How low could factory employment go in Ontario and Quebec? In the U.S., U.K and Australia, employment in manufacturing as a share of total jobs has fallen from 14-16% in the early 1990s to about 10% in 2007 – or 4 percentage points lower than the prevailing share in Ontario and Quebec. For illustrative purposes, if the proportion of





jobs in these provinces matched the 10% manufacturing job share by 2012 (and assuming a moderate rate of 1-1.5% annual average gains in overall employment), Ontario and Quebec would experience further job losses of 250,000 and 100,000 over the next half decade.

Governments have a key role

Governments also have a role to play in supporting manufacturers as they adjust to the new realities. Actions that increase support for investment, training and border infrastructure would help to soften the blow, while reducing ongoing trade barriers between provinces should be top priorities. Canada's weak track record in R&D remains an issue despite what appears on paper to be generous tax treatment. For example, changes that would raise businesses' use of the federal SR&ED incentive, such as reductions in administrative complexity, would certainly help.

Recent moves by the federal government to cut its corporate income tax rate and Ontario to eliminate the capital tax on manufacturing marked steps forward. Furthermore, the 2-year accelerated capital cost allowance for manufacturers who make equipment purchases by the end of 2008 – a program that will hopefully be extended in the upcoming budget – should assist in stimulating capital spending. Quebec recently released a manufacturing strategy that includes a number of initiatives designed to help manufacturers cope. In addition to establishing a manufacturing council to provide recommendations on boosting the overall sector's longer-term competitiveness, the Premier of Ontario has asked MPP David Ramsay to propose immediate measures to assist small and medium-sized manufacturing enterprises ahead of the 2008 budget.

That being said, there are limits to what a government can do in the short run in the face of the tsunami of headwinds, notably the U.S. slowdown. In other words, there is no quick fix and ill-thought-out programs could provide few benefits while coming at significant costs to the treasury. Since the challenge for manufacturers is long-term in nature, the best option for public policy officials is to embark on a longer-term plan, say 3-5 years. Given that budgets will be short of revenues in the short run, measures can to some extent be back-end loaded but not to the extent that they lack credibility.

Above all, the longer-term strategy should encompass knocking down the impediments to growth in all sectors in Ontario and Quebec, not just manufacturing. This broader focus would not only help manufacturers directly, but also recognizes that many producers – notably SMEs – still earn the bulk of their revenues domestically. In fact, only 20% of manufacturers directly engage in exporting activities. It also faces up to the point that the Ontario and Quebec economies will become increasingly reliant on non-manufacturing areas for jobs, income and prosperity over the long run.

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