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OBSERVATIONS

Dennis DesRosiers

State of the Canadian Automotive Sector

The Canadian Automotive Workers Union recently released a study indicating that Canada was about to see a record deficit in automotive trade of about $8 billion. The study went on to conclude that this was the end of the automotive industry in Canada as we know it (their words, not mine). At the very least, they claimed that the trade deficit will be extremely negative for the Canadian industry.

My first observation is that the CAW study is generally correct in its statement that Canada's balance-of-trade in automotive products is deteriorating. Although the $8 billion estimate quoted in the CAW study is likely high by one-to-two billion dollars, the deficit is indeed moving in a troubling direction.

It is, however, also important to answer the simple question of WHY? The CAW blames the trade deficit on overseas imports and foreign markets (particularly Korea). An unbiased analysis clearly shows that it is not the weakness of Canada's automotive sector - rather, the problem lies with a number of other factors, including [ironically] the strength of Canada's automotive assembly sector.

Our assembly sector is performing very well this year relative to the U.S. and Mexico. Our imports of automotive parts are up by about a billion dollars, particularly from U.S. manufacturers. Canadians are also buying a near-record number of new vehicles this year, so our imports of vehicles have also risen by roughly a billion dollars. These two factors alone count for more than half the change in our balance-of-trade. The American market is struggling this year, so our exports of new vehicles to the US are down by around two billion dollars. Despite the weakness in the US market, our automotive parts exports are actually up slightly this year.

I would argue that a strong assembly sector is good for Canada and that the same is true for our automotive parts sector. The notion that a large deficit is the "end of the automotive sector in Canada as we know it" is just not true.

The CAW report goes to great lengths to blame all this on overseas imports and overseas markets. I agree with all the voices in this debate that are calling for Korea (or any other country) to eliminate any and all tariff and non-tariff barriers. We can't, as a nation, take a boy-scout's view to foreign trade. A careful look at the trade data indicates that Canada's balance-of-trade with Korea, Japan and the EEC is down. China is up slightly, but it is building from a very small base. Collectively, there is absolutely no change in Canada's balance of automotive trade with overseas countries. Where did this projected $6 to $8 billion deficit come from if it didn't come from overseas?

Quite simply, the entire problem is with the U.S. and virtually no other country. Therefore, the CAW's call for strong protectionist measures

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against our foreign competitors would appear to be misdirected since they are not the problem. Indeed, if the CAW was honest with their policy position, one would think that they would have come out with guns blazing asking for restrictions on U.S. imports. After all, the deterioration in our automotive trade account is primarily with the United States. Of course, our NAFTA Agreement would make a serious protest difficult, but this would also mean that the CAW would have to take on GM, Ford and Chrysler who are part of this large deficit with the U.S. and that would be politically difficult for them.

The major takeaway from this situation is the danger inherent in looking at balance-of-trade data on its own. When analyzing Canada's automotive sector, it is important to look many variables: exports, imports, capital expenditures, employment, production, productivity, R & D expenditures, etc. Zeroing in on balance-of-trade data can result in some very misleading results.

These variables show a very mixed performance within the Canadian automotive sector. Vehicle production is down very slightly this year with a drop from 2.75 million units to 2.71 million units, but this is because the North American market is down by about a half million units and Canada sells to the entire North American market. More importantly, Canada's share of North American vehicle assembly is actually tracking at an all-time high of 17.5 percent. The new Toyota plant in Woodstock will be coming on stream within a year, the GM investment in Zeta platform production in Oshawa is about a year away, and there has been a near-complete renewal of all but one of our other assembly plants. The only assembly plant in Canada that would appear vulnerable is the Ford Talbotville plant near London, Ontario. Even if we lose the Ford plant (by no-means a certainty), these new investments should result in Canada increasing its share of North American assembled vehicles to roughly 18 percent by the end of the decade. Our assembly sector appears to be in fairly decent shape in the short term.

Longer term, there is a concern over the new labour agreements negotiated in the U.S. The UAW seems to have finally figured out that the future of any OEM resides in product, product, product. As part of their settlement with GM and Chrysler (we expect Ford as well), they negotiated strong product commitments for many U.S. assembly plants. This is not to say that Canada and or Mexico will never get another product - future product decisions are just going to be more competitive for Canada to land. There will likely have to be some severe cost reductions in Canada if we are going to maintain our share of North American production over the longer term, but in the near term our assembly sector is in very good shape.

Much has been made of the threat to Canada's manufacturing competitiveness as a result of the par dollar with the U.S. This is

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Canadian Automotive Industry Trade with All Countries - ($Cdn Millions)

	Exports			Imports			Balance of Trade		
	Total Motor Vehicles	Total Automotive Parts	All Automotive Products	Total Motor Vehicles	Total Automotive Parts	All Automotive Products	Total Motor Vehicles	Total Automotive Parts	Total All Automotive Products
July									
2006 YTD	33,317.7	13,085.3	46,403.0	23,350.6	22,880.2	46,230.8	9,967.1	(9,794.8)	172.3
2007 YTD	31,082.8	13,192.3	44,275.1	24,284.3	23,764.5	48,048.8	6,798.5	(10,572.2)	(3,773.6)
2007 YTD/2006 YTD	-6.7%	0.8%	-4.6%	4.0%	3.9%	3.9%			

Canadian Automotive Industry Trade with the U.S. - ($Cdn Millions)

	Exports			Imports			Balance of Trade		
	Total Motor Vehicles	Total Automotive Parts	All Automotive Products	Total Motor Vehicles	Total Automotive Parts	All Automotive Products	Total Motor Vehicles	Total Automotive Parts	Total All Automotive Products
July									
2006 YTD	32,876.4	11,928.9	44,805.3	16,220.3	17,763.9	33,984.2	16,656.1	(5,835.0)	10,821.1
2007 YTD	30,535.8	11,960.3	42,496.1	17,141.1	18,452.5	35,593.6	13,394.7	(6,492.2)	6,902.5
2007 YTD/2006 YTD	-7.1%	0.3%	-5.2%	5.7%	3.9%	4.7%			

Canadian Automotive Industry Trade with Countries other than the U.S. - (Cdn$ Millions)

	Exports			Imports			Balance of Trade		
	Total Motor Vehicles	Total Automotive Parts	All Automotive Products	Total Motor Vehicles	Total Automotive Parts	All Automotive Products	Total Motor Vehicles	Total Automotive Parts	Total All Automotive Products
July									
2006 YTD	441.2	1,156.4	1,597.7	7,130.3	5,116.3	12,246.5	(6,689.0)	(3,959.8)	(10,648.8)
2007 YTD	547.0	1,232.0	1,779.0	7,143.2	5,312.0	12,455.2	(6,596.2)	(4,080.0)	(10,676.2)
2007 YTD/2006 YTD	24.0%	6.5%	11.4%	0.2%	3.8%	1.7%			

Note: Exports exclude re-exports

Source: DesRosiers Automotive Consultants Inc. and Industry Canada

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certainly a concern in some sectors, but our vehicle assembly sector has a natural currency hedge that blunts much of the impact. Assemblers in Canada import roughly 85 percent of their raw materials and components, and the par dollar obviously makes these imports a lot cheaper. The OEMs get hurt on the other side of this equation since they export about 80 percent of the vehicles they produce. Putting the two together creates a natural hedge that helps Canada - not entirely, but to a large degree.

NORTH AMERICAN SALES OF VEHICLES - # OF UNITS
-INCLUDES HEAVY DUTY TRUCK

Year	US Total	Canada Total	Mexico Total	North America Total	Canada as a % of N.A.	Mexico as a % of N.A.
2000	17,811,673	1,586,054	902,372	20,300,099	7.8%	4.4%
2001	17,472,378	1,597,875	942,431	20,012,684	8.0%	4.7%
2002	17,138,652	1,731,823	1,003,861	19,874,336	8.7%	5.1%
2003	16,967,442	1,625,050	999,106	19,591,598	8.3%	5.1%
2004	17,298,573	1,574,803	1,119,585	19,992,961	7.9%	5.6%
2005	17,444,329	1,630,142	1,126,778	20,201,249	8.1%	5.6%
2006	17,048,981	1,666,008	1,134,402	19,849,391	8.4%	5.7%
2006/2005	-2.3%	2.2%	0.7%	-1.7%		
2007 Tracking	16,563,794	1,733,686	1,110,200	19,407,681	8.9%	5.7%
YTD Change	-2.9%	2.8%	-2.2%	-2.3%		
2007 F	16,500,000	1,700,000	1,110,000	19,310,000	8.8%	5.7%
2008 F	16,100,000	1,618,041	1,050,000	18,768,041	8.6%	5.6%
2009 F	16,500,000	1,607,067	1,100,000	19,207,067	8.4%	5.7%
2010 F	17,400,000	1,638,067	1,250,000	20,288,067	8.1%	6.2%

Source: DesRosiers Automotive Consultants Inc., AIAMC, Asociacion Mexicana de la Industria Automotriz, A.C., Automotive News, CVMA & Ward's Automotive Reports

The importing of such a high volume of automotive parts to build vehicles is at the root of the real weakness in Canada's automotive sector: the parts industry. Our automotive parts sector has never been as strong as the assembly sector throughout the entire history of the automotive industry in Canada. The Autopact rationalized vehicle assembly in Canada and provided a strong footing on which to grow this aspect of our automotive sector. However, at the same time, we exposed our parts sector to serious competition from the U.S. We lost dozens of plants in the post-Autopact period. Canada's auto parts sector has recovered from this, but the recovery was never complete enough to withstand other economic shocks. Energy crises in the mid-1970s and early-1980s resulted in the collapse of vehicle demand (and production) and once again our parts sector was exposed to difficult economics. The automotive parts sector appeared to recover through the 1990's and some strong players emerged like Magna International, Linamar, Westcast etc. Employment in the automotive parts sector grew from about 50 thousand workers to roughly 100 thousand workers. Unfortunately, these successes were not enough to put the automotive parts sector on a firm footing. For the most part, the smaller suppliers in Canada existed and grew through the 1990s because of a very weak dollar (low 60 cent range). However, most did not invest in the latest technology and equipment. Capital expenditures in our parts sector averaged in the 5 to 8 percent range of North American investments in most years compared to over 20 percent in the assembly sector. If suppliers don't invest, it is very difficult for them to be competitive when economics turn against the sector. This is exactly what has happened with the strength of the Canadian dollar. In a relatively short period of time, suppliers have been exposed to a rapidly appreciating currency. They are now finding it very difficult to stay competitive.

We are fortunate in that we have managed to attract into Canada over a hundred overseas-based suppliers who were following their OEM customers into the North American market. However, these new suppliers were not enough to offset the weaker players who - for the third time in

NORTH AMERICAN PRODUCTION TO SALES RATIOS
-INCLUDES HEAVY DUTY TRUCK

Year	US Total	Canada Total	Mexico Total	North America Total
2000	71.7%	186.8%	213.1%	87.0%
2001	65.4%	158.6%	197.1%	79.0%
2002	71.6%	152.1%	179.8%	84.1%
2003	71.2%	157.1%	157.7%	82.8%
2004	69.1%	172.2%	138.7%	81.2%
2005	68.5%	164.9%	149.5%	80.8%
2006	66.1%	164.8%	180.3%	80.9%
2007 Tracking	64.7%	156.2%	188.1%	79.9%
2007 F	64.5%	159.9%	187.9%	80.0%
2008 F	64.2%	164.9%	196.6%	80.3%
2009 F	64.0%	172.4%	195.6%	80.6%
2010 F	64.1%	179.4%	185.1%	80.9%

Source: DesRosiers Automotive Consultants Inc., AIAMC, Asociacion Mexicana de la Industria Automotriz, A.C., Automotive News, CVMA & Ward's Automotive Reports

(continued on next page)

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the last four decades - are presently undergoing a significant downsizing. This is evident in employment numbers that show the automotive parts sector peaking three years ago at about 98,000 workers and since that time losing around 10,000 jobs. The parts sector has not lost all of the gains achieved through the 1990s, but it is certainly in a lot of trouble with more downside likely before any turnaround could potentially occur.

When our assembly sector is doing quite well, Canada always sees a deteriorating balance-of-trade in automotive parts since this sector does not have the capacity to keep up with demand for its product. The Canadian automotive parts sector is still comprised primarily of smaller Tier II and Tier III companies who struggle to invest and compete with better capitalized and more sophisticated competitors in the U.S. Shouldn't addressing this issue be the focus of government policy rather than the CAW's repeated suggestion to move to a more protection-oriented policy environment. These companies will never get stronger if they can hide behind protectionist policies and/or a weak Canadian dollar. In some respects, the strong Canadian dollar may help the automotive parts sector, which will see weaker players fall to the side and stronger players step forward. Dominant companies will increase investments in new equipment, and they will form joint ventures with overseas players around the world.

New Capital Expenditures in Canada and the US ($Cdn millions)

Year	United States	Canada	North America	Canada Percent
Assembly Sector				
2000	$7,096	$1,806	$8,902	20.3%
2001	$6,884	$2,338	$9,221	25.3%
2002	$7,533	$2,206	$9,739	22.6%
2003	$7,244	$2,843	$10,087	28.2%
2004	$6,100	$2,260	$8,360	27.0%
2005	$4,954	$2,327	$7,281	32.0%
2006	$4,310	$3,039	$7,348	41.4%
2007	$3,846	$2,014	$5,860	34.4%

Year	United States	Canada	North America	Canada Percent
Parts Sector				
2000	$13,163	$905	$14,068	6.4%
2001	$12,968	$683	$13,651	5.0%
2002	$11,867	$1,097	$12,964	8.5%
2003	$10,396	$1,005	$11,401	8.8%
2004	$8,146	$1,008	$9,155	11.0%
2005	$8,240	$820	$9,060	9.0%
2006	$8,052	$960	$9,012	10.6%
2007	$8,132	$1,202	$9,334	12.9%

Assembly and Parts Sector

Year	United States	Canada	North America	Canada Percent of N.A.
2000	$20,259	$2,711	$22,970	11.8%
2001	$19,852	$3,021	$22,872	13.2%
2002	$19,401	$3,303	$22,703	14.5%
2003	$17,640	$3,848	$21,488	17.9%
2004	$14,246	$3,268	$17,514	18.7%
2005	$13,194	$3,147	$16,341	19.3%
2006	$12,362	$3,998	$16,360	24.4%
2007	$11,978	$3,216	$15,194	21.2%

Source: DesRosiers Automotive Consultants Inc., Statistics Canada, U.S. Census Bureau and the U.S. Department of Commerce

One of the most positive aspects of Canada's current automotive sector performance is the level of capital expenditures witnessed during the last few years. Whereas in the 1990's many in the automotive parts sector did not invest, over the last few years they have stepped up and increased their investments to a little over 10 percent of Canada-U.S. investments. Most of this increase is the result of overseas suppliers investing in Canadian facilities. Although capital expenditures in the parts sector have not increased noticeably, the U.S. components sector has seen significant reductions allowing Canada to capture higher shares.

In addition, the OEMs have committed massive dollars to renew their plants in Canada. For most of the last decade, Canada has been able to attract well over 20 percent of North American vehicle assembly capital expenditures, so it should come as no surprise that we are on the verge of producing close to 20 percent of assembled vehicles. Capital expenditures have also been in the high-$2 billion range in an era where similar investments in the U.S. have deteriorated badly, falling from $7 billion per year to around $4 billion.

In sum, our automotive sector gets a mixed report card. The OEMs and the assembly sector would earn B+ to A- marks. Our automotive parts sector would earn passing grades, but not much more than a C-. DAR

Employment in the Canadian Automotive Manufacturing Sector

Year	Assembly Sector	Percent Change	Parts Sector	Percent Change	Total Automotive Manufacturing	Percent Change	Tool, Die, Mould Sector	Percent Change
1991	53,298		65,416		118,713		18,606	
2000	55,712	-2.1%	98,154	5.3%	153,866	2.5%	26,255	-3.3%
2001	53,205	-4.5%	98,894	0.8%	152,099	-1.1%	26,384	0.5%
2002	52,038	-2.2%	96,803	-2.1%	148,840	-2.1%	25,648	-2.8%
2003	49,971	-4.0%	98,334	1.6%	148,305	-0.4%	27,425	6.9%
2004	50,114	0.3%	97,342	-1.0%	147,456	-0.6%	27,939	1.9%
2005	49,808	-0.6%	96,540	-0.8%	146,347	-0.8%	27,575	-1.3%
2006	47,460	-4.7%	92,315	-4.4%	139,774	-4.5%	28,232	2.4%
2007YTD Avg.	48,074	1.3%	88,091	-4.6%	136,165	-2.6%	25,788	-8.7%

Source: DesRosiers Automotive Consultants Inc. and Statistics Canada SEPH Survey

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