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The Three Eras of Automotive Manufacturing in Canada

Rarely does a week go by that we don't hear some rumblings about auto industry job losses, corporate bailouts, or the creation of new trade barriers? Opposition politicians, trade associations and union representatives continue to float these ideas, but to what end? With selected exceptions, most of these policy initiatives would have a highly negative effect on the Canadian automotive industry, laying the seeds for further discontent and future failure. In order to understand how the manufacturing community has arrived at the present juncture, it is necessary to delve into its history. As I've said before, history isn't the study of the past; rather, it's how our predecessors dealt with the present.

The Canadian automotive manufacturing sector – including both parts production and vehicle assembly – has passed through three distinct eras during its first century in business. The first period, running from the beginnings of this industry in the early 1900s until the creation of the AutoPact in 1965, can be termed the High Tariff Era.

The High Tariff Era

In its earliest years, vehicles were manufactured in Canada to take advantage of the favourable tariff structure enjoyed by countries in the British Commonwealth.

With protectionist import tariffs hovering north of 20 percent, Canadian automotive manufacturing developed in a rather inefficient manner. Dozens of different makes and models

were produced for a relatively small domestic marketplace, leaving OEMs and their suppliers few chances to realize economies of scale similar to what their American counterparts were seeing. Despite the small production runs necessitated by these tariff barriers, it was still less expensive to build in Canada than to source vehicles from American factories. The automotive parts sector evolved in tandem with automotive manufacturing in Canada, so it too was small, fragmented, and highly inefficient.

By the early 1960s, prices were high and margins were slim. Bowing to pressure from loci across the Canadian automotive industry – as well as accumulating trade deficits and a general sense of manufacturing malaise – our government established a royal commission headed by Vincent Bladen, Dean of Business at the University of Toronto to look into the problem. The Bladen commission recommended a series of duty remission programs aimed at the rationalization of the myriad overlaps and redundancies plaguing Canadian auto manufacturing – programs intended to ultimately reduce the cost of vehicles in Canada.

Vocal lobbying from American parts manufacturers (penalized under the Bladen recommendations) prompted the Canadian government to reconsider Bladen's duty remission approach. Trade negotiations between the Canadian and American governments were entered into and, in 1965, the Canada – U.S. Automotive Products Trade Agreement was born.

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The Auto Pact Era

January 16th, 1965 marked the beginning of the second major phase of automotive assembly and parts manufacturing in Canada. In its simplest terms, the Auto Pact can be thought of as the complete elimination of duties for new vehicles and original equipment parts. True free trade, however, was far from the agreement's effect, as the Auto Pact also established a wall of highly-punitive non-tariff barriers known euphemistically as 'safeguards.'

These safeguards were well-intentioned and entirely appropriate given the historical context into which they were introduced. In the early 1960s, boardroom talk in Windsor and Ottawa often drifted towards the question of whether Canada had the capability of establishing and supporting its own auto industry or if dependency on GM, Ford, and Chrysler was not only the best option, but realistically the only option. The ruling pragmatists correctly determined that the possibility of an indigenous Canadian owned and operated car company was quite unlikely, and they opted to place the future of our auto industry in the hands of the big American-owned multinationals. Had economic safeguards not been erected, there was a fear that Canada would simply become a warehouse for the companies that were being relied upon to sustain our industry and thus no manufacturing jobs would evolve.

The agreed-upon safeguards forced GM, Ford, and Chrysler into doing two things. First, they needed to meet a strict production-to-sales ratio that guaranteed one vehicle produced (of equal value) for every vehicle sold in Canada. This not only guaranteed a large-scale manufacturing presence in Canada, but that said manufacturing base would be the beneficiary of continual investment and updating.

Second, manufacturers building vehicles in Canada were required to meet a Canadian value-added quotient to ensure that their products had significant Canadian content. This stipulation formed the basis for our parts manufacturing sector.

While these safeguards were eventually a boon for Canadian manufacturing, they caused early and immense grief among parts suppliers that had failed to invest in their facilities. The inefficiencies associated with the later years of the High Tariff Era came home to roost, weeding out weaker players and sparking the near-decimation of many smaller Canadian parts manufacturers. Between half and two thirds of these companies could not compete with larger US outfits, so they simply disappeared. In their stead, those same U.S.-based multinationals established Canadian operations and took up the parts supply mantle.

Eventually, a core of stable Canadian-owned organizations grew up under the umbrella of prosperity created by the natural explosion of vehicles in North American society during the 1960s and early 1970s. This growth was

aided by the efficiencies and Canada-centric advantages created by the Auto Pact, and it was because of these factors that history considers the Auto Pact to have been an extremely successful trade agreement. It encouraged companies to invest and re-invest in the latest manufacturing technologies, and it encouraged U.S.-located businesses to funnel money towards their Canadian operations. It provided a framework upon which was built our own indigenous auto parts industry.

Much of this good news was overlooked in the Auto Pact's early years, as the failure of existing inefficient Canadian players was a far more sensational news story than the slow growth of a healthier and more multi-national manufacturing industry. Had we known then what we know now, it's possible that a longer lens may have been used by contemporary newsmen and prognosticators.

The fundamental flaw of the Auto Pact – indeed, the factor that led to its downfall and demise – was its restriction of benefits to North American players. As import nameplate vehicle manufacturers grew in prominence, sales volume, and market share, Official Canada searched for ways to help these offshore OEMs increase their manufacturing presence in this country. These companies could never qualify for Auto Pact status so various 'remission' schemes were cooked up.... none of them effective. The Auto Pact could not stand the test of time and did not accommodate the internationalization of the auto sector.

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Having paved the way for a fit and stable Canadian automotive manufacturing industry, the Auto Pact also began to wither and die with the establishment of the first Canada-U.S. Free Trade Agreement in 1989 and the ratification of NAFTA in 1994. A Japanese-instigated WTO challenge determined that the Auto Pact contravened WTO rules. This challenge ultimately felled the Auto Pact in 1999, bringing to an end the second era of the automotive manufacturing sector in Canada.

There's no denying that the Auto Pact was successful in its time, but this success was based on non-tariff barriers. These safeguards were a major growth impediment in an industry that was (and still is) rapidly globalizing. With the striking-down of the Auto Pact, a new era of Canadian automotive manufacturing had begun.

The Globalized Era

Although the creation and dismantling of the Auto Pact provides convenient dates between which we can easily demarcate the various eras dealt with in this Observation, the actual break-points being dealt with are fairly soft. As a case in point, the globalized era did not start immediately upon the fall of the Auto Pact, nor is it a phenomenon confined primarily to the current decade. The globalized Canadian auto sector grew during the 1990s and came to fruition after the Auto Pact had ended, but it would be incorrect to mark 1999 as the present era's true beginning.

Regardless of when it actually began, one thing is for certain: Canada's auto sector is currently developing along global guidelines. Honda has two assembly plants, Toyota has one with another being built, GM and Suzuki have a joint venture plant, and more than 150 non-North American multinational parts suppliers have followed their client OEMs and poured investment dollars into Canadian facilities. Our markets are now split almost evenly between American nameplate products and import nameplate vehicles (though more than half of these global nameplate cars and trucks are actually manufactured in North America). Despite the fact that this new era is barely a decade old, the degree of penetration attained by global players into the heart of Canadian vehicle manufacturing and retailing is nothing short of astonishing.

In the early years of the globalized era, parts manufacturers and vehicle OEMs were able to do quite well primarily thanks to an artificially low Canadian dollar which frequently flirted with the 60 cent mark. With historical perspective, we now know that the decline of GM, Ford and Chrysler was more-or-less inversely proportional to the rise of the import nameplate fortunes, so that many jobs eliminated in ongoing GM-Ford-Chrysler capacity reductions were replaced with jobs at the New North American OEMs' plants.

At the time, however, the U.S. automakers' decline seemed to be progressing quite slowly. The market grew rapidly at the beginning of this decade, and although GM, Ford, and Chrysler didn't participate

in the upside, there wasn't much of a downside. Share was lost but volumes remained.

Today, however, a number of elements have changed quite significantly and the U.S.-based OEMs have been required to undertake radical restructuring plans in order to remain solvent. Most importantly, the North American market has seen no growth over the past few years. Energy prices have soared, deflating the sales of Detroit's mainstay Intermediate and Large SUV products. Collectively, GM, Ford, and Chrysler have reduced production by approximately four million units per year. Whether or not they have indeed reduced production capacity by that amount is debatable, but this development is certainly a healthy step.

From a Canadian perspective, we have our strong resource sector to thank for the newfound U.S. parity of our dollar. The preferential treatment given to GM, Ford, and Chrysler during the Auto Pact era resulted in high exposure to those companies and their suppliers, so the elimination of the artificially low Canadian dollar removed a major investment incentive. Canada has been left highly exposed to the side of the industry going through the most aggressive downsizing.

On the vehicle manufacturing side, Canada has (thus far) emerged in a relatively neutral position due to our successful attraction of several global assembly players and their associated suppliers. If anything, we are in a slightly better position

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than during the Auto Pact years, consistently tracking at roughly 17 percent of the North American production total (versus 16 percent through the 1980s).

Parts manufacturers have traveled a rougher road. The Canadian parts manufacturing sector is proportionally smaller and more fragile than its assembly sector counterpart. As the Canadian auto parts industry restructured in the early years of the Auto Pact era, it benefited enormously from its exposure to GM, Ford, and Chrysler. Together with the arrival of international parts manufacturers following global OEMs in the 1980s and 1990s, our parts sector grew from around 50,000 workers in the mid-Auto Pact years to around 100,000 workers in the beginning of the Globalized Era.

However, in the past few years, this well has begun running dry. The sector's high exposure to the Detroit-based vehicle companies – together with its relative reluctance to invest under the protection of a low dollar and Auto Pact safeguards– has resulted in a noticeable scaling-back during the middle and later years of this decade.

The fundamental problem with the Canadian owned side of our parts industry is that – with a few important exceptions – the majority of players are second or third tier companies that have lacked the capital, management talent, and motivation to become internationally competitive. Many of these companies have failed to maintain their investments, and

have certainly NOT innovated either on the factory floor or with new products, and as a result they are now losing contracts and shedding employees. We are presently going through another wide-scale parts sector restructuring not unlike the situation in the early Auto Pact years.

With 300 to 500 Canadian-owned second and third tier companies, fifty to one hundred global multinationals, and thirty to fifty American multinationals, the Canadian parts sector is still a strong component of the larger automotive industry. The global suppliers that have chosen to invest in Canada are quickly becoming the new backbone of this sector. Exceptions are possible in every regard, but in many cases they use the most modern equipment and processes to produce the most modern products. They are playing to the growth side of this industry.

American multinationals are responsible for the much of the negative news coming out of the Canadian parts sector. Few of these invested in heavily R&D in Canada and never funneled innovation dollars alongside their production money. At the present time they are consolidating and rationalizing primarily because their customer base has shrunk radically.

We are confident that GM, Ford, and Chrysler will find a way to survive (if not thrive) in the Globalized Era. They have largely completed the first, most painful step towards future solvency that is defined as downsizing – though there still remain legacy plants, such as Ford's St. Thomas facility, facing

uncertain futures. Phase two is also well underway and that is defined as re-structuring: the renegotiation of labour and supplier contracts to ensure future stability. Labour has started to accept its role in the industry's return to health. And newfound clout has enabled and will continue to enable vehicle OEM negotiators to force their suppliers to be more globally-competitive – to access the best product technologies and become the equals of their foreign-market counterparts.

The Detroit-based vehicle companies have also begun the third phase of their respective recoveries: reinvestment in their best products and factories. Products like the Ford Edge and GM's GMT900-series pickup trucks prove that winning design and efficient, high quality manufacturing is a successful combination. This three part strategy.... resize, re-structure, re-invest will stabilize the Detroit three which should standardize the Canadian parts sector.

The current era of auto sector manufacturing in Canada is marked by a lack of tariff and non-tariff protection, significant expenditures on innovation (related to both product and manufacturing technologies), and quick uptake of emerging technologies. At some point during the next two to three years, our parts sector will emerge from its downturn and begin to grow again. It may lose another 5,000 to 10,000 jobs in the process, but the resulting core will be – to borrow a term from the technology industry – "future proofed" to a far greater degree than before. **DAR**