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## The Canadian auto industry's difficulties are far from over

The Canadian auto industry has significant challenges, both structural and cyclical in nature, to overcome. This means not only a reduction of production but also significant job losses. At the same time, domestic sales remain strong while the trade balance in auto products has deteriorated greatly. These difficulties especially affect Ontario's growth and a slight recession is possible in the first half of 2008. These problems are likely to continue in the next few years, but quick action is needed to ensure that the Canadian auto industry will carry on. In this context, the current round of negotiations will be crucial for the competitiveness of plants across the country.

### CONTEXT AND HISTORICAL BACKGROUND

The first automobile plant in Canada opened its doors in 1904 with the establishment of the Ford Motor Company of Canada by Gordon McGregor one year after Henry Ford began mass producing cars in Detroit. Other Canadian automobile plants will subsequently open. General Motors of Canada was founded in 1918 as a result of the merger of McLaughlin Motor Co. Ltd. and Chevrolet Motor Co. of Canada.

However, it will be necessary to wait until the end of World War 2 to see demand truly spread throughout the middle class and production step up significantly. In 1960, Chrysler, Ford and General Motors (GM) had all established branches in Canada, but most of the North American production was located in the United States. At the time, Canada had a significant trade deficit, which brought about the Royal Commission on the Automotive Industry. This commission led to an agreement on automotive products, i.e., the "Auto Pact", which Canada and the United States signed on January 16, 1975. Under this agreement, the tariffs were eliminated on the trade of automotive products between Canada and the United States, thus setting up a larger unified market for this industry. This helped establish larger more efficient plants to meet demand in both countries. The Auto Pact also involved guarantees for Canada concerning investments and domestic production. As a result, for each automobile sold in Canada, U.S. companies agreed to produce at least one automobile in Canada. Each Canadian-built car

was also required to have a national content of at least 60%, whether in parts or labour.

Many changes were brought to the Auto Pact over time. Changes would also be needed for the free trade agreement reached between Canada and the United States in 1989 and later for the ratification of the North American Free Trade Agreement (NAFTA) between Canada, the United States and Mexico in 1994. The existence of these agreements greatly reduced the need for a separate agreement for the auto industry. Meanwhile the increase in international trade led some foreign manufacturers to criticize the preferential treatment from which U.S. companies benefited from under the pact. The European Union and Japan complained to the World Trade Organization (WTO) and the Auto Pact was abolished in 2001.

### IMPORTANT STRUCTURAL CHANGES ARE UNDER WAY

The Canadian auto industry reached its peak as we entered the new millennium. The number of vehicles produced during a 12-month period totalled 2.8 million units between July 1999 and June 2000. Close to 157,000 workers were employed in auto assembly or parts plants in early 2001. However, many disruptive factors subsequently brought on a gradual consolidation and restructuring process, which led to a gradual reduction of production and jobs. According to the latest data, the Canadian production of automobiles barely reached 2.2 million units in the last few months, i.e., a 20% decline in comparison with its peak in 2000 and the number

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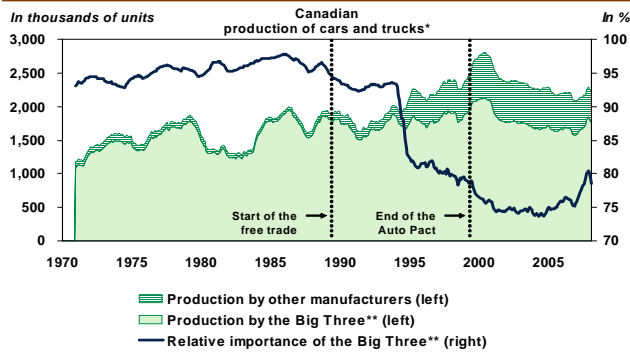
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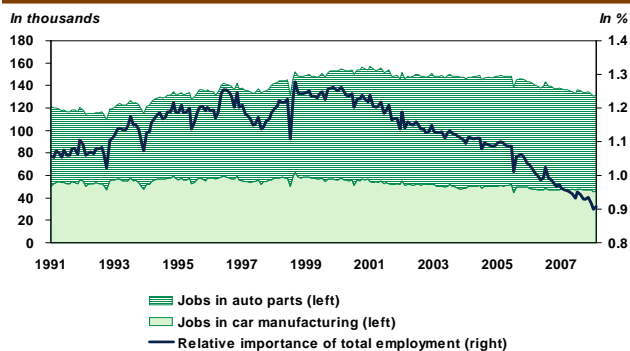
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**Graph 1 – Automobile production has been decreasing since 2000**



**Graph 2 – The number of jobs in the auto industry is declining**

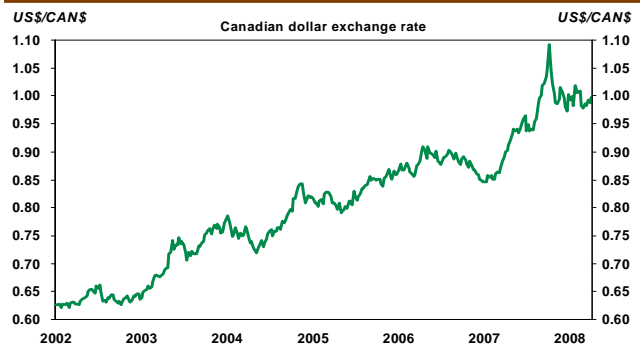


of jobs in the industry totalled approximately 130,000 (Graphs 1 and 2).

A good share of this decline is of course attributable to changing preferences among consumers. It is well known that world demand for Big Three (GM, Ford and Chrysler) products has been declining and replaced by so-called “foreign” manufacturers such as Toyota, which recently overtook GM becoming the leading car manufacturer in the world. Over time, the existence of the Auto Pact definitely helped Big Three plants the set up in Canada and the presence of foreign companies has remained all in all limited. In fact, from the early seventies up to the late eighties, the Big Three were producing close to 95% of all vehicles built in Canada. The opening of plants that manufactured “foreign” models slightly changed the order of things. The relative importance of the Big Three in automobile production in Canada dropped to approximately 75% in 2004. Even if this share has recovered slightly since the Canadian auto industry still depends significantly on the production of the Big Three. In this context, the market losses that they suffered over recent years have had a direct impact on domestic production.

However, many other challenges have been adding on over the years increasing the Canadian industry’s difficulties. First, the strong appreciation of the loonie that has been going on for several years is greatly affecting the competitiveness of Canadian manufacturers (Graph 3). From 2003 to 2007, the Canadian dollar appreciated by 58% in comparison to the greenback. All things being equal, this means that Canadian auto manufacturers’ costs (especially wages) expressed in U.S. dollars are now much higher than before.

**Graph 3 – The loonie has appreciated substantially**



Second, the recent labour negotiations fairly changed the picture with respect to labour costs among the Big Three. If negotiations are still ongoing for most Canadian plants, the process is almost fully completed south of the border. American workers have made a number of concessions to cut the labour costs for the Big Three and so increase their competitiveness in relation to foreign manufacturers. The talks that have been going on up to now in Canada, especially with Ford, have unfortunately not produced such great adjustments. Unless there is a major change, Canadian plants could become the most expensive auto production areas in North America.

Third, the marked increase in fuel prices could become problematic for the Canadian auto industry. As is evident in Table 1, Canadian automobile assembly plants produce very few compact or subcompact models. In fact, most models produced in Canada are large sedans, minivans, pickups or sports utility vehicles. In short, almost all models are big gas guzzlers. In a context where many consumers are increasingly turning to more fuel-efficient automobiles in reaction to increasing fuel prices, the Canadian industry does not seem to be well positioned.

Lastly, over the past several months, the structural problems of the Canadian industry have come with less favourable market conditions while demand for new cars has significantly slowed down south of the border. The difficulties in the

**Table 1**  
**Major factories assembling motor vehicles in Canada**

	<i>Region</i>	<i>Products</i>
<b>Personal vehicles</b>		
CAMI*	Ingersoll, Ontario	Chevrolet <i>Equinox</i> , Pontiac <i>Torrent</i> , Suzuki <i>XL-7</i>
Chrysler	Brampton, Ontario	Chrysler <i>300</i> , Dodge <i>Magnum</i> , Dodge <i>Charger</i>
	Windsor, Ontario	Dodge <i>Caravan</i> , Chrysler <i>Town &amp; Country</i> , Chrysler <i>Pacifica</i>
Ford	Oakville, Ontario	Ford <i>Freestar</i> , Ford <i>Edge</i> , Lincoln <i>MKX</i>
	St. Thomas, Ontario	Ford <i>Crown Victoria</i> , Mercury <i>Grand Marquis</i>
GM	Oshawa 1, Ontario	Chevrolet <i>Monte Carlo</i> , Chevrolet <i>Impala</i>
	Oshawa 2, Ontario	Buick <i>LaCrosse</i> ( <i>Allure</i> in Canada), Pontiac <i>Grand Prix</i>
	Oshawa 3, Ontario	GMC <i>Sierra</i> , Chevrolet <i>Silverado</i>
Honda	Alliston 1, Ontario	Honda <i>Civic</i> , Acura <i>CSX</i>
	Alliston 2, Ontario	Acura <i>MDX</i> , Honda <i>Pilot</i> , Honda <i>Ridgeline</i>
Toyota	Cambridge 1, Ontario	Lexus <i>RX350</i>
	Cambridge 2, Ontario	Toyota <i>Corolla</i> , Toyota <i>Matrix</i>
	Woodstock, Ontario	Toyota <i>RAV4</i> (production begins in November 2008)
<b>Heavyweights and average weight trucks</b>		
International Trucks	Chatham, Ontario	9200 Series, LoneStar et ProStar (heavyweights trucks)
Sterling Trucks	St. Thomas, Ontario	Acterra (average weight trucks)
Paccar of Canada Ltd	Sainte-Thérèse, Québec	Kenworth et Peterbuilt (average weight trucks)
<b>Bus</b>		
Nova Bus	Saint-Eustache, Québec	Public transportation buses
Canadian Blue Bird Coach Ltd.	Brantford, Ontario	School buses
Chrysler	Windsor, Ontario	Minibus 10 to 15 passengers
Girardin	Drummondville, Québec	School buses
Motor Coach	Winnipeg, Manitoba	Tourist Buses
New Flyer	Winnipeg, Manitoba	Public transportation buses
Orion	Mississauga, Ontario	Public transportation buses
Prévost Car	Sainte-Claire, Québec	Tourist Buses

\* Canadian Automotive Manufacturing Inc. (joint venture of GM and Suzuki).  
Sources: Industry Canada and Desjardins, Economic Studies

U.S. real estate market and their impact on household income are leading consumers to reconsider their purchases of durable goods. In addition, the tightening of credit conditions in U.S. financial institutions has limited access to financing. So new car sales in the United States are down 11.2% in comparison to the spring of 2007, which translates of course into lower demand for Canadian exports of auto products.

Obviously, the numerous difficulties are leaving more and more marks. The number of full or partial shutdowns by Canadian manufacturers has multiplied in the past few months. The latest is the announcement by General Motors that it will be shutting down one of its plant in Oshawa and its transmission plant in Windsor in 2010. Ford has also recently announced a reduction in the production, which should particularly affect the Canadian St. Thomas and Windsor (V8 engine making) plants.

In this period of intense union negotiations, one last factor that recently affected the production of automobiles in North

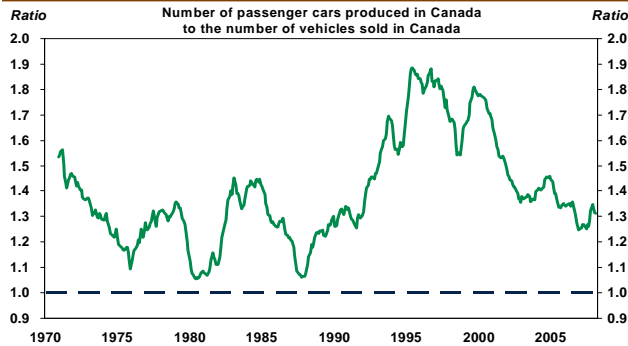
America relates to the many strikes started recently. They have significantly shaken up production.

With so many structural and cyclical problems to overcome, the Canadian automobile industry is not expected to recover in the short term. On the contrary, bad news should probably build up in the next few years. Like in previous quarters, the automobile industry's difficulties will continue to hinder economic growth in 2008, 2009 and maybe even beyond.

The impact of a decline of this nature on economic growth is observed in the many job losses mentioned previously and its effect on the international trade of goods in Canada. This means that Canada's relative production<sup>1</sup> has decreased significantly in the last few years. The ratio of the number of vehicles produced in Canada to the number of vehicles sold

<sup>1</sup> The relative production is equal to the production of automobiles in the country in comparison to the number of vehicles purchased on the domestic market.

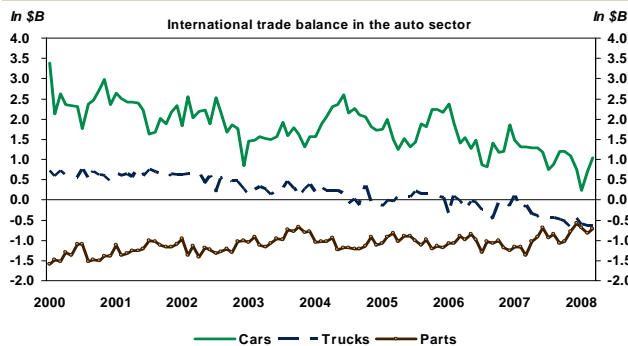
**Graph 4 – Canada's relative production is decreasing**



Sources: Statistics Canada and Desjardins, Economic Studies

on the domestic market dropped from a peak of 1.88 in May 1995 to approximately 1.31 in early 2008 (Graph 4). Nevertheless, it is interesting to notice that this ratio remains above the single unit despite the scrapping of the old Auto Pact (that guaranteed that at least one vehicle be produced for each vehicle sold). However, the decline of this ratio over the last few years means a significant deterioration of the trade balance in new vehicles (cars and trucks) between Canada and other countries. As far as passenger cars are concerned, exports are barely above imports while a deficit amounting to several hundreds of millions is recorded every month for trucks (Graph 5). Taking into account the historical

**Graph 5 – The car surplus is decreasing**

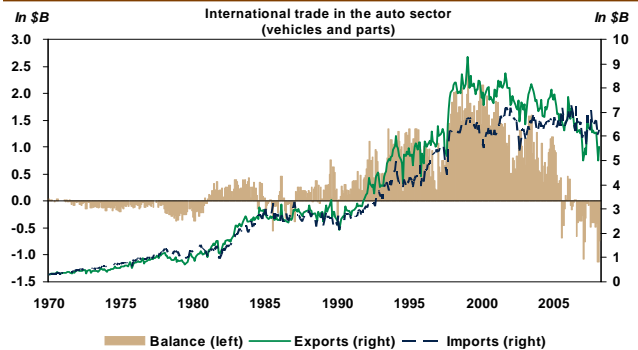


Sources: Statistics Canada and Desjardins, Economic Studies

deficit in the parts business, it is obvious that the trade balance for automobile products has gradually deteriorated over the last few years. In fact, 2007 closed on a 2.3B\$ deficit, i.e., the most disappointing balance since 1980. According to the results for the first three months of 2008, the deficit could be even worse in 2008 and reach its lowest level since the data was first recorded in 1971 (Graph 6).

As most of the production is based in Ontario (the main assembly plants are located there), the economic growth of this province is more seriously affected by the difficulties of

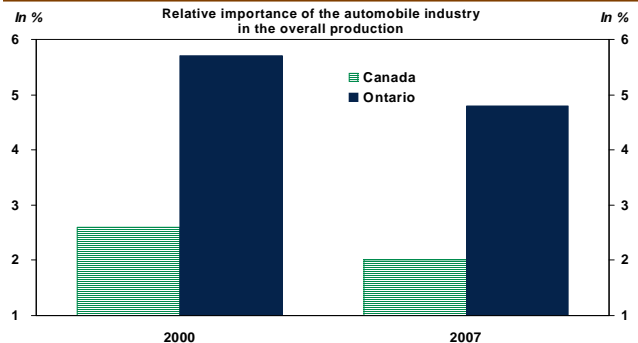
**Graph 6 – The worst international trade record since 1980**



Sources: Statistics Canada and Desjardins, Economic Studies

the auto industry than the rest of the country. For instance, the relative importance of the auto industry in Ontario's production was 4.8% in 2007 vs. 2.0% in all of Canada and only 0.2% for the nine other provinces (Graph 7).

**Graph 7 – Ontario is more dependent on the automobile industry**



Sources: Statistics Canada and Desjardins, Economic Studies

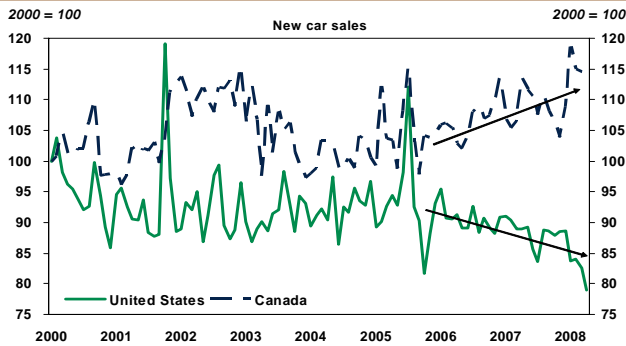
As a result, the auto sector took away approximately 0.6% on average from Ontario's economic growth over the last two years. The ongoing structural and cyclical problems of the Canadian auto industry over the next quarters will probably contribute negatively to real GDP to the same extent. In fact, should the current increase in fuel prices continue, the negative impact of the auto industry on Ontario's economic growth should be even more significant.

These difficulties add to the damaging effects of the appreciation of the loonie and the decline of U.S. demand on the entire manufacturing sector in Ontario. In this context, the growth outlook for Ontario's economy is significantly below the national average for 2008 and 2009. In fact, Ontario will probably be the only Canadian province to go through a classic recession in 2008, with a slight decline of real GDP in the first half of the year.

**DOMESTIC DEMAND REMAINS STRONG**

The deterioration of international trade in auto products stems of course from the decreasing production of vehicles and parts in Canada, but also from the relatively robust progress in domestic sales. As is evident in Graph 8, passenger car sales have been trending upwards in Canada for a few years, a situation that is out of place with what can be observed in the United States where auto sales are dropping. This vitality

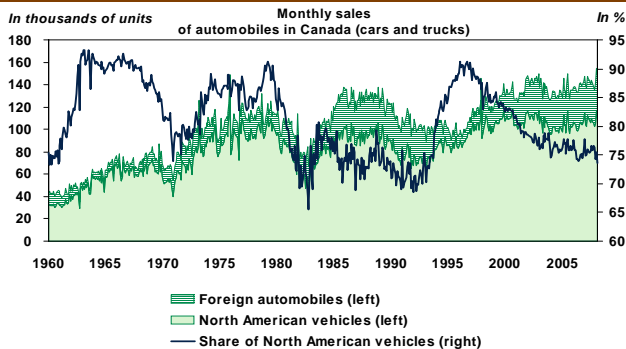
**Graph 8 – Divergent trend in sales**



Sources: Statistics Canada and Desjardins, Economic Studies

in Canadian auto sales is of course conducive to an increase in imports, all the more since the demand for foreign models (with the exception of those made by GM, Ford and Chrysler) is increasing domestically. While the vehicle brands of the Big Three accounted for close to 90% of Canadian sales in 1996, they now have only 75% of the market (Graph 9).

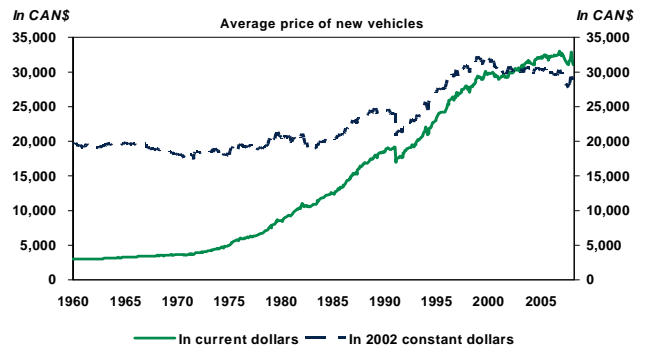
**Graph 9 – American models are not as popular**



Sources: Statistics Canada and Desjardins, Economic Studies

Several combined factors contribute to and explain the vitality of Canadian car sales. On the one hand, the average price of new cars only increased slightly over the past few years and even decreased recently. Expressed in 2002 constant dollars to take inflation into account, the average price of automobiles has been decreasing since early 2000 (Graph 10). In other words, the relative price of new cars has significantly decreased over recent years. This can be explained in part by

**Graph 10 – Car prices are going down slightly in real terms**



Sources: Statistics Canada and Desjardins, Economic Studies

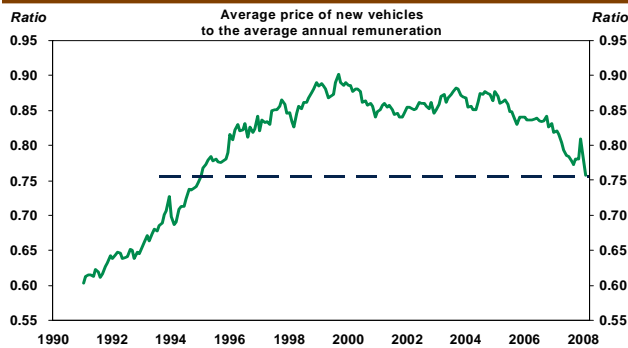
the strong appreciation of the dollar, which considerably reduced the price for imported goods. Moreover, price adjustments even intensified last fall when the Canadian dollar was trading at par with the greenback, which made comparisons between Canadian and American prices easier. In addition, the weak demand for automobiles in the United States encouraged many manufacturers to propose purchase incentives that were in most cases also offered to Canadian consumers. Anaemic demand south of the border also boosted the vehicle offer in Canada, which also contributed to low prices at home. Lastly, the Federal government recently introduced two 1% GST cuts. This measure is beneficial to consumers but is rather limited overall, except for the purchase of more expensive durable goods such as automobiles.

At the same time, the Canadian labour market is showing remarkable buoyancy. While the manufacturing sector suffered significant job losses in recent years, the vitality of domestic demand is supporting jobs in the service sector, so much so that in the end the Canadian labour market is showing substantial gains. This is reflected in the unemployment rate that remains near its 33-year low and in wage growth that is far exceeding inflation. Of course, this job creation combined with a wage increase is a situation that encourages auto sales.

The decrease in auto sales and the increase in wages have impacted the affordability of new automobiles. One of these measures, i.e., the ratio of the average price of new automobiles to the average annual remuneration per individual, significantly decreased in the last few years. With an average price representing approximately 75% of the annual remuneration in the beginning of 2008, buying a car has never been so affordable since the mid-nineties (Graph 11).

More recently, also contributing to auto sales are the interest-rate cuts. The Bank of Canada already introduced four cuts

**Graph 11 – Buying a new car is very affordable**

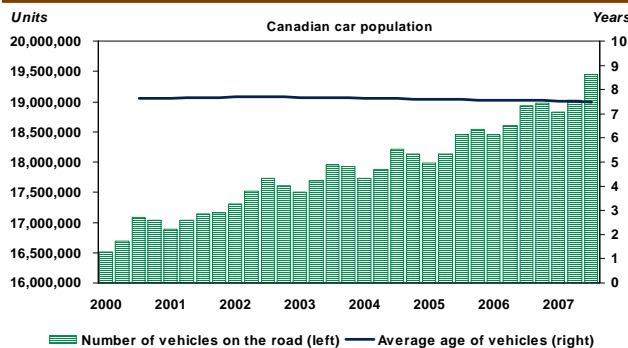


Sources: Statistics Canada and Desjardins, Economic Studies

of the target rate in overnight funds since the end of 2007, which also brought down the financial institutions' prime rate from 6.25% to 4.75%. These cuts in the prime rate are not only reflected in the rates offered by financial institutions for car loans but also in the rate offered by various financing organizations owned by auto manufacturers.

Lastly, even if new car sales have been rather brisk of late, the car population is not really getting any younger. On average, automobiles were between 7 and 8 years old in 2007, i.e., a level that is almost identical to the one observed in the beginning of the new millennium (Graph 12).

**Graph 12 – A fleet that has not rejuvenated despite the sales increase in new cars in recent years**



Sources: Statistics Canada and Desjardins, Economic Studies

In short, many factors bolstering automobile sales are combined and the outlook for the number of vehicles sold remain relatively good. After increasing by 1.4% in 2007, the number of automobiles sold in Canada began 2008 strong with a monthly gain of nearly 9% last January. This constitutes significant growth experience for the overall annual sales progress for 2008. Nevertheless, our scenario anticipates some slowdown in the number of vehicles sold over the coming months due mainly to the recent increase in fuel prices. The price increase at the pump has shaken the confidence of

Canadian households last spring and a decrease in household confidence usually comes hand in hand with a slowdown in consumer spending, especially durable goods. In the end, the total number of new automobiles sold in Canada could still increase slightly in 2008, marking the fourth consecutive annual increase.

**CHALLENGES IN STORE...**

The coming years might be crucial for the long-term survival of the Canadian auto industry. If several elements seem ready to inhibit the production of automobiles in Canada over the short and even medium term, the changes that may or may not be brought over the next few years will be crucial for the long-term future of this industry. In this context, the current round of negotiations with the Canadian auto workers is key. Manufacturers could be asking for significant concessions to obtain gains in efficiency. If not, the loss of competitiveness of Canadian plants could eventually mean a dwindling presence of auto manufacturers in Canada. With growing globalization and the abolition of the Auto Pact, there are no more guarantees that auto manufacturers, especially North American ones, will remain present in Canada. So conditions have to be brought together for them to stay.

The global auto industry should also be going through a period of technological adjustments over the next decades with increased concerns for the environment (it has even already begun). Here lies an opportunity for the Canadian auto industry. It should be taking advantage of innovations (engines and batteries for electric cars) and facilities (factories and research centres) that are present in Canada. Unfortunately, there is still much work to be done in this area when you consider the relative importance of energy-consuming vehicles in the current Canadian production.

Finally, the slowdown of production combined with the relatively high level of new car sales in Canada mean that the deterioration of international trade in auto products will definitely be continuing over the coming years.

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