

economic LETTER

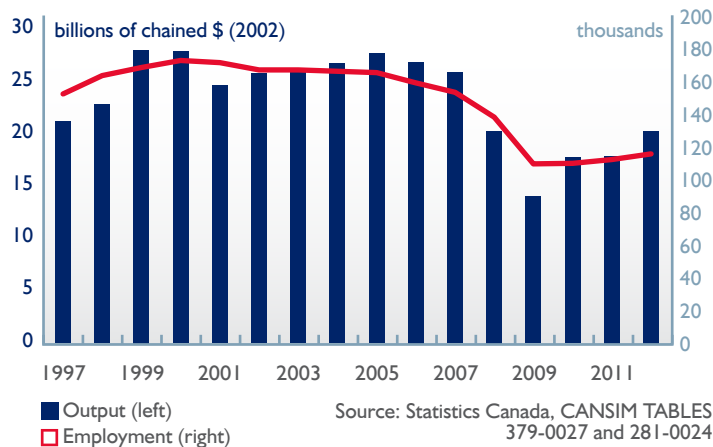
JULY-AUGUST 2013

THE CANADIAN AUTOMOBILE INDUSTRY: TRENDS AND OUTLOOKS

At the end of the 1990s, the Canadian automobile industry was in great shape. The volume of production was at its peak, and the industry was generating over 170,000 direct jobs (Graph). During the 2000s, the industry underwent a profound transformation due to the growing popularity of cars manufactured in Asia, particularly in Japan, to the detriment of North American cars. This change in consumer preferences caused a collapse in the market shares of the three traditional North American giants: General Motors, Ford and Chrysler.

At the beginning of this century, the Canadian auto industry was mainly dependent on these three major manufacturers, so production started to decline. However, while the North American manufacturers were closing plants in Canada, Japanese automakers undertook to manufacture more vehicles here. Many Japanese manufacturers, including Toyota and Honda, already had plants in North America, built in the 1990s. Between 1998 and 2006, the Canadian production ▼

**Production and wage-earning employment
in the Canadian auto industry**



Note: For 2012, output is estimated using the monthly average of the January to October period

Canada

- > Slight growth in real GDP
- > Employment is unchanged
- > Housing starts decline, but home sales increase
- > The trade deficit shrinks a bit

United States

- > Real GDP is revised downwards
- > Employment maintains a steady pace of growth
- > Housing starts make little progress, but home sales remain firm
- > The trade deficit widens

Interest rates

The key interest rate should remain stable between now and the end of the first quarter of 2014

Oil and dollar

SME confidence

Credit conditions

Key indicators

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of Japanese automakers doubled.¹ We should point out that Japanese cars garnered much more enthusiasm in Canada than in other parts of the world, which helped spur local production by Japanese automakers.

The increase in Japanese car production in Canada helped curb the decline of Canadian auto production. However, the industry was obliged to face other challenges, in particular the appreciation of the Canadian dollar against its American counterpart and rising gasoline prices. The appreciation of the loonie drove up the costs (including wages) of Canadian auto plants, expressed in U.S. dollars, reducing their competitiveness. Furthermore, most of the vehicles manufactured in Canada were models with high fuel consumption, which put the Canadian auto industry in a very bad position at a time when high gasoline prices were stimulating demand for more fuel-efficient vehicles.²

Just when the auto industry was already going through a rough patch, the 2009 recession hit, causing sales and production to plummet. Demand for cars has picked up since then, and these indicators have rallied, but they have not returned to where they stood before the recession. Nor has employment, which declined gradually after 2005 before plunging in 2009, recovered the losses that were sustained during this period. In 2012, the number of wage-earners in the Canadian auto industry stood at around 115,000, having dropped by one third from what it was at the beginning of this century.

What lies ahead for the Canadian auto industry? This year, production will decline if General Motors closes its Oshawa plants as expected. The increased capacity of the Toyota plant in Cambridge and the possible expansion of the Ford

plant in Oakville will not be enough to offset the production decline stemming from the closure of the GM plant. In the years to come, Canadian auto manufacturing could find itself in serious trouble. The direst threat is without a doubt the strength of the Canadian dollar, which has eliminated the cost advantage the Canadian industry enjoyed a few years ago. Carmakers are now turning to places where production costs are lower, such as the southern United States and Mexico; many have announced the intention of building new plants or expanding those that already exist there.

The future may seem bleak, but there is hope. The collective agreements with the three major North American automakers, which were ratified last fall by the members of the Canadian Auto Workers union and call for lower wages for new employees and more seniority before reaching the top of the wage scale, should help make the industry more competitive. On another front, the Automotive Innovation Fund (AIF), which provides support to auto sector companies for conducting research focused on developing more eco-friendly vehicles with lower fuel consumption, was renewed in 2013 for another five years and continues to bear fruit. Toyota will take advantage of the AIF to expand its production of the Lexus model and to begin production of the Lexus hybrid, in Cambridge, Ontario. Moreover, following the tsunami that struck Japan in 2011 and generated serious turbulence in the production chain, automakers are feeling a need to diversify the production of auto parts.³ This intent to diversify and rising global demand for automobiles stemming from growth in the emerging countries offer real opportunities for the Canadian auto industry. ■



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Job growth slowed significantly in the first half of 2013; housing starts are down and, despite a recent uptick, home sales will probably be lower than they were last year; merchandise exports are starting off the second quarter with a downturn. In short, the latest indicators are quite consistent with forecasts of very modest economic growth in 2013.

Slight growth in real GDP

Real GDP gained 0.1% in April compared with the previous month. Of the major categories, the finance and insurance sector posted the strongest monthly growth, followed by wholesale and retail trade. Manufacturing production also rose, but at a more moderate pace. Production fell back in the construction sector, but it was mining, oil and gas extraction that reported the largest pullback in April. According to the Consensus, real GDP growth will come in at around 2.0% in the second quarter compared with the previous quarter (at an annualized rate) and will be 1.7% for 2013 compared with the previous year. ▼

¹ *Canadian Economic Observer*, "Canada's Changing Auto Industry," May 2007, Statistics Canada, no 11-010.

² Desjardins Economic Studies, *The Canadian auto industry's difficulties are far from over*, Economic Viewpoint, June 3, 2008.

³ TD Economics, *Canadian auto manufacturing: Running again, but how much fuel is left in the tank?*, Observation, April 19, 2013.

Employment is unchanged

In June, the reduction in full-time jobs was nearly even with the increase in part-time jobs (-32,400 vs. +32,200); as a result, total employment hardly budged (Graph). Meanwhile, the unemployment rate was stable at 7.1%. The professional, scientific and technical services sector recorded the strongest monthly growth in employment, while accommodation and food services, and the information, culture and recreation sector logged the sharpest drops. In the first six months of 2013, the average monthly variation in employment was half that of the previous six months, i.e. 13,567 versus 26,817. Moreover, it was the creation of full-time jobs that slowed the most, falling from a monthly average of 24,850 jobs between July 2012 and December 2012, to a monthly average of just 6,500 jobs from January 2013 to June 2013.

Monthly Change in Employment (July 2012 to June 2013)



Housing starts decline, but home sales increase

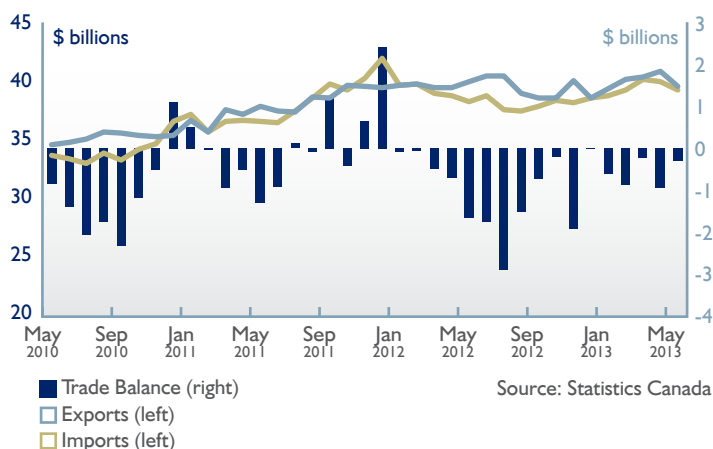
Housing starts were down to 199,586 in June, having fallen from 204,616 units in May (seasonally adjusted and annualized figures). In urban centres, starts of single-family homes dropped by 4.1%, and those of multiple-unit homes, by 2.0%. The trend in housing starts, based on the six-month moving average, was practically flat compared with the previous month, which is in

line with the forecasts of the Canada Mortgage and Housing Corporation (CMHC). According to the CMHC's latest forecasts, housing starts will fall by nearly 15% in 2013 and then pick up by 3.3% in 2014. Meanwhile, home sales recorded a third straight increase in May. Sales have now returned to the level they stood before the entry into force of new mortgage rules that caused serious deceleration in the resale market. According to the Canadian Real Estate Association, Canada's real estate market now stands firmly in a balanced position.

The trade deficit shrinks a bit

Because imports contracted twice as fast as exports (3.2% vs. 1.6%), the trade deficit shrank, from \$951 million in April to \$303 million in May. The drop in imports is mainly accounted for by energy products, and the metal ores and non-metallic minerals sector. Motor vehicles and parts, and metal and non-metallic mineral products also contributed to the decline. The downturn in exports largely comes from metal and non-metallic mineral products, and from motor vehicles and parts. The trade surplus with the United States widened slightly, from \$3.4B in April to \$3.5B in May, while the trade deficit with countries other than the United States narrowed, from, \$4.4B in April, to \$3.8B in May. ■

International Trade (May 2012 to May 2013)



The labour market is improving slowly but surely, and the same can be said of the housing market. The U.S. Federal Reserve appears confident: President Ben Bernanke recently mentioned the possibility of scaling back the Reserve's bond purchases if the economic situation keeps improving.

Real GDP is revised downwards

Real GDP growth in the first quarter of 2013 has been revised downwards, from 2.4% to 1.8%. This revision is mainly due to weaker growth in consumer spending than was previously estimated (2.6% vs. 3.2%).

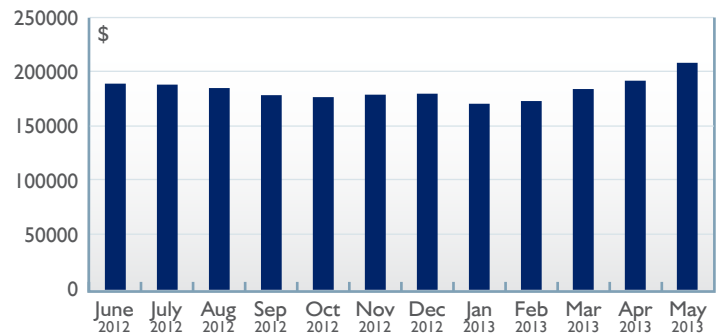
Employment maintains a steady pace of growth

Posting net creation of 195,000 jobs in June, employment maintained the rate of growth it has shown in recent months. The unemployment rate was stable, at 7.6%. For the first six months of 2013, the average monthly variation in employment is 202,000, a better performance than that of 2012, when the monthly average stood at 183,000. Despite this improvement, the labour market still has a way to go before it reaches a healthy state. The number of discouraged workers (that is, those who have withdrawn from the labour force because they are convinced they will not find work) and those who are working part time for economic reasons (because their employer has reduced their work hours or because they cannot find full-time work) is still high.

Housing starts make little progress, but home sales remain firm

After declining by 14.8% in April, housing starts rose by just 6.8% in May, so they are far from regaining the ground lost in the previous month. Starts of single-family homes rose by just 0.3%, while those of multiple-unit homes surged by 24.9%. As for home sales, they were up by 4.2% in May compared with the previous month, and by 12.9% compared with the same month last year. Moreover, the median price, which surpassed US\$200,000 in May, is still climbing (Graph). According to the National Association of Realtors, robust growth in new households combined with pent-up demand built up in recent years and a shortage of newly built homes are helping to support growth in home prices.

Sales Price (median) of Existing Single-Family Home
(June 2012 to May 2013)

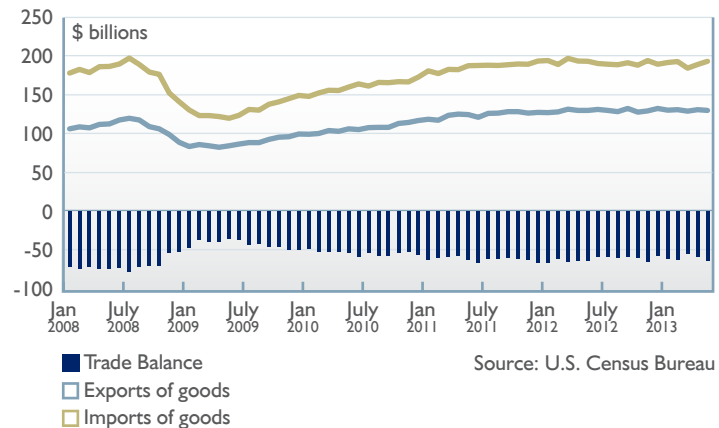


Source: U.S. National Association of Realtors

The trade deficit widens

Exports of goods fell back by \$0.9B in May compared with the previous month, reaching \$130.2B, while imports advanced by \$4.2B to reach \$193.7B. Consequently, the trade deficit expanded, from \$58.4B in April to \$63.4B in May. After shrinking considerably during the recession of 2009 due to a sharper drop in imports than in exports, the trade deficit has been gradually widening ever since (Graph). It has been relatively stable since the beginning of 2011, fluctuating around an average of \$62B, which is below where it stood before the recession, around \$69B. (Note that the amounts mentioned in this paragraph are in U.S. dollars.)■

United States International Trade
(January 2008 to May 2013)



Source: U.S. Census Bureau

The key interest rate should remain stable between now and the end of the first quarter of 2014

The Bank of Canada will no doubt leave its key interest rate unchanged in its next monetary policy decision, on July 17. In fact, according to the Consensus, which comprises around 15 forecasters, the key interest rate will probably remain stable at least until the end of the first quarter of 2014. This is hardly surprising, given that the Consensus is expecting real GDP growth of just 1.7% in 2013. In July, the central bank will also release its Monetary Policy Report. As for the

U.S. Federal Reserve, it will keep its benchmark interest rate steady between 0 and 0.25% for as long as the unemployment rate stays above 6.5%, provided the expected inflation rate over the next year to two years does not exceed 2.5% and the long-term inflation expectations remain firmly grounded. The Fed is still buying \$40B of mortgage bonds and \$45B of Treasury bonds every month, but President Ben Bernanke recently mentioned, at a press conference, the possibility that the institution might reduce its bond purchases this fall if the economy improves as expected. ■

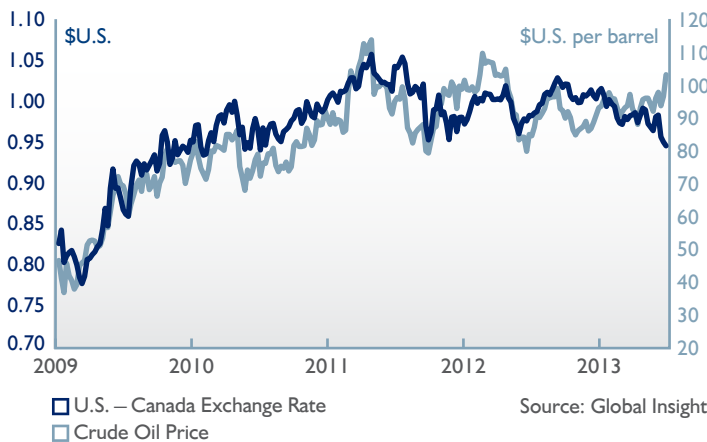
 **OIL AND THE LOONIE**

The price of oil climbs while the Canadian dollar depreciates

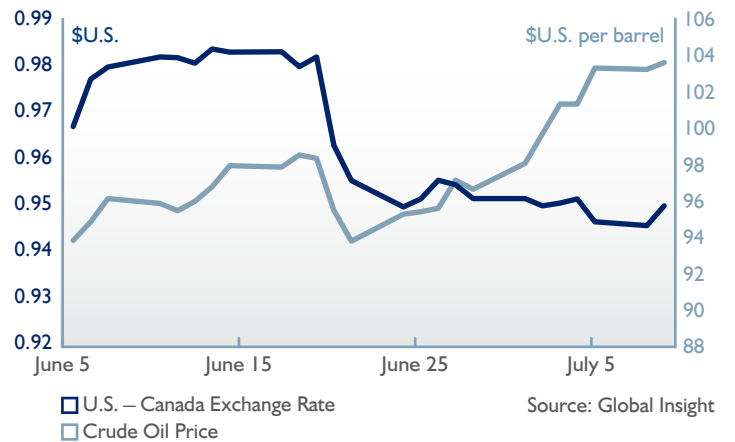
Several factors put upwards pressure on the price of crude oil in June, including tensions in Egypt, where Prime Minister Mohamed Morsi was ousted by the army. Egypt does not export oil; however, it not only has the Suez Canal, but also a large network of pipelines, and it sits at the hub of crude oil shipments from North Africa and the Gulf region. Better-than-expected American data on employment and household

consumption also helped drive up the price of crude. At the same time, the statement by the Federal Reserve's President that monetary expansion measures might be tapered off in the months to come caused the U.S. dollar to appreciate against many currencies, including the Canadian dollar. Employment data, which were better than expected in the United States and lower than anticipated in Canada, exacerbated the depreciation of the loonie against the greenback. ■

Exchange Rate and Crude Oil Price
(January 2009 to July 2013)



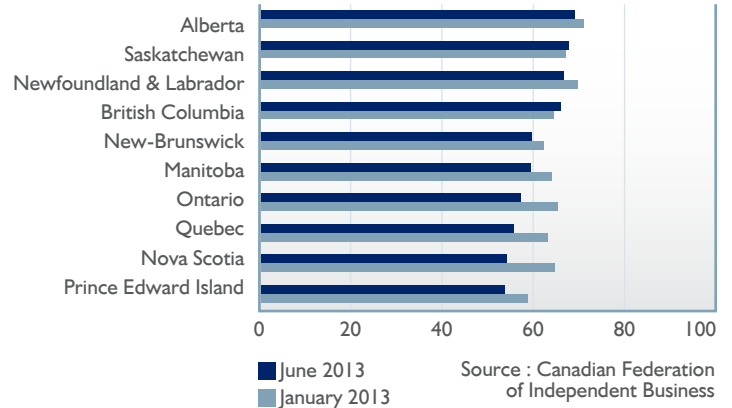
Exchange Rate and Crude Oil Price
(June 5, 2013 to July 9, 2013)



Business confidence wanes further

For the fourth straight month, the Canadian Federation of Independent Business (CFIB) Business Barometer Index has lost ground. It fell by nearly three points, from 62.1 in May to 59.4 in June. This is the first time since July 2009 that it has stood below the 60 mark. Since the beginning of the year, confidence has ebbed in nearly all the provinces, but the drop was much sharper in the central and eastern provinces (Graph). The percentage of business owners who believe the lack of domestic demand is limiting their sales or production growth has increased, from 36% in January to 40% in June. Hiring intentions are also gloomier than they were at the beginning of the year: the percentage of respondents who expect to hire staff in the next three months has sunk, from 27% in January to 20% in June. ■

Business Barometer, by province
(June 2013 and January 2013)



BUSINESS CREDIT CONDITIONS

According to businesses, credit conditions have changed little, while they have eased according to the financial institutions

According to the Bank of Canada's Senior Loan Officer Survey (SLOS), overall business credit conditions continued to ease in the second quarter of 2013; however, according to the Business Outlook Survey (BOS), also conducted by the Bank of Canada, they did not change, overall, during that period (Graph). We would point out that the SLOS presents the point of view of financial institutions, while the BOS presents that of businesses. The data from these two surveys are balances of opinion, i.e. the percentage of respondents who consider that credit conditions have tightened, minus the percentage of those who consider that they have eased. Incidentally, neither survey provides any indication of the extent of such tightening or easing. ■

Business Credit Conditions
(balance of opinions, %)



Key indicators – Canada	Historical ¹				2013 ²				2013 ³	Forecast	
	2009	2010	2011	2012	Q1	Q2	Q3	Q4	Latest	2013	2014
Real GDP (% growth)	-2.7	3.4	2.5	1.7	2.5				Apr	0.1	1.7 2.4
Machinery and Equipment Expenditures (% growth)	-21.2	10.6	8.6	5.2	-0.7						1.9 5.9
Pre-Tax Corporate Profits (% growth)	-45.4	61.6	16.6	-8.2	16.7						-1.7 5.3
Industrial Production (% growth)	-10.9	6.3	3.8	0.9	4.9				Apr	-0.4	2.0 2.5
Industrial Product Prices (% growth)	-3.5	1.0	4.6	0.6	0.9				May	0.0	1.2 2.0
Non-Residential Construction (% growth)	-19.4	17.3	12.9	6.9	1.5						
Housing Starts ('000 units)	148	191	193	215	174				Jun	200	176 171
Personal Expenditures (% growth)	0.3	3.5	2.3	1.9	0.9						1.8 2.1
Consumer Price (% growth)	0.3	1.8	2.9	1.5	1.6				May	0.2	1.3 1.9
Employment (% growth)	-1.6	1.4	1.5	1.2	0.8	1.3			Jun	0.1	
Unemployment Rate (%)	8.3	8.0	7.5	7.3	7.1	7.1			Jun	7.2	7.1 6.9
SMEs Confidence Index (CFIB)	57.7	66.7	66.4	63.9	64.9	61.3			Jun	59.4	
Manufacturers Confidence Index (CFIB)	56.0	68.6	67.2	66.7	65.7	58.3			Jun	55.6	

1. Annual growth rate

2. Quarterly growth, at annual rate

3. Month-over-month growth

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business.



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