Economics

Wanted: New Plants — A Hurdle For Canadian Manufacturing Growth

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Typically, coming out of a deep recession, the last thing you need to worry about is spare capacity. It often takes years of growth before existing facilities are running full tilt and in need of sister plants or expansions. But the period of retrenchment in Canadian manufacturing after 2005, one that predated the recession, featured so many permanent closures, that winning new plant mandates is now a major hurdle that will stretch out the recovery's timetable.

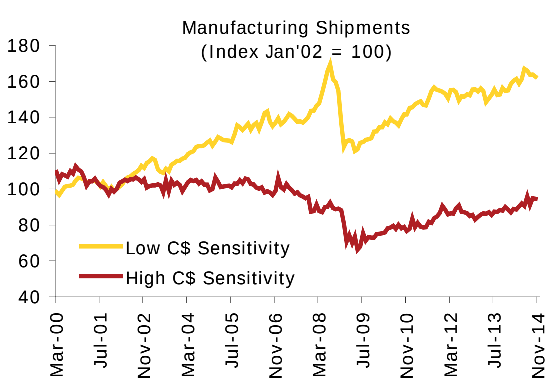
Bumping Up Against Capacity

The revival of domestic demand post-recession, an accelerating US economy, and more recently, a weakened loonie has provided the lifeblood for a recovery in Canadian manufacturing in the past few years. That the currency has been a big part of the story is well evidenced by the earlier underperformance of manufacturing activity in sub-sectors that had historically been sensitive to the exchange rate during the C$'s climb post 2002. More recently, these sectors are rebounding now that the loonie is weaker (Chart 1). Given that the Canadian dollar is down a further 5% since November, it's tempting to conclude that there's a further steep climb ahead.

But while there's a will, there may not be a way, at least not immediately. Although real factory output is still well below pre-recession levels (Chart 2 left), many manufacturers will be bumping up against capacity constraints, as capacity use is already at typical pre-recession levels (Chart 2, right). The reason: so much capacity was permanently shuttered in the 2005-2013 period, as the recession left North America

Chart 1

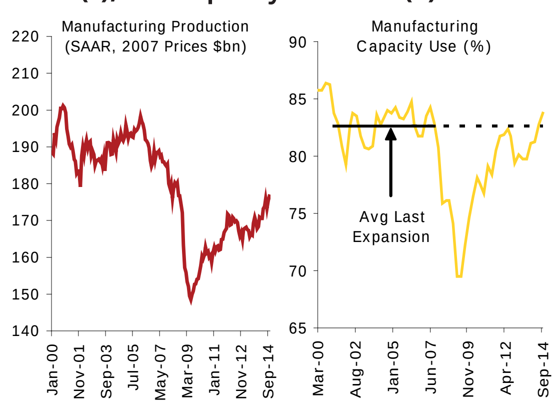
High C$-Sensitive Sectors* Underperformed Since 2002



Source: Statistics Canada, CIBC
**as defined in BoC research*

Chart 2

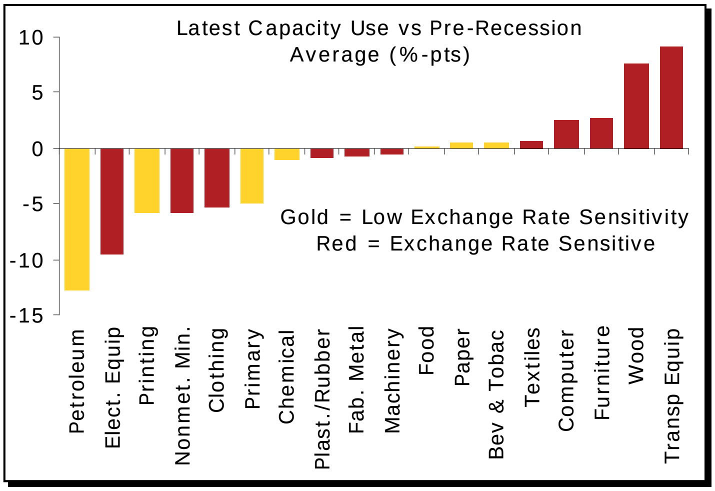
Production Still Below Pre-recession Peak (L), But Capacity Use Isn't (R)



Source: Statistics Canada, CIBC

Chart 3

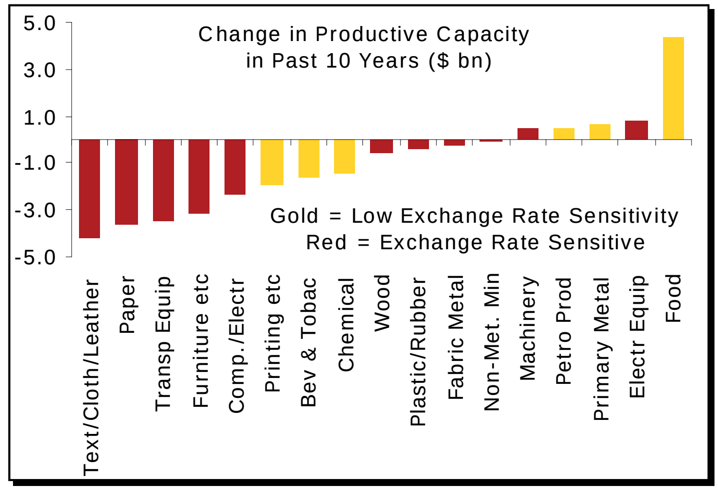
C$-Sensitive Sectors the Most Stretched



Source: Statistics Canada, CIBC

Chart 4

Exchange Rate Sensitive Sectors Saw Biggest Capacity Retreats



Source: Statistics Canada, CIBC

with too much capacity, and Canada's strong currency made costs look elevated on this side of the border.

Closures Left Their Mark

Looking at individual industries, the largest, transportation equipment, is also the furthest above its typical capacity-use rate, joined by four other industries that are all among those previously sensitive to the exchange rate (Chart 3).

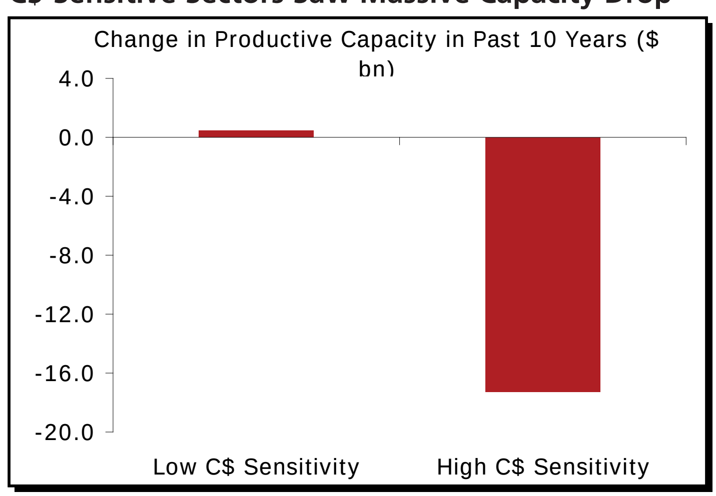
The litany of auto assembly and parts plant closures during the strong loonie era is well known. Despite the recent currency correction, there's been a dearth of positive announcements on capacity additions on this side of the border, as there can be a considerable lag from a move in the spot rate to its business investment decisions made over many quarters. The aggressive use of subsidies by other jurisdictions has also been a factor for assembly plants. Parts plants decisions have been impacted by the southward shift in the geographic centre of the assembly industry with Mexico and southern US states gaining share. For all of transportation equipment, that has left productive capacity down more than 10% from levels a decade earlier.

But it's not just in autos and parts. Across the full spectrum of manufacturing, available capacity has melted away in the past decade. Again, the tie to the exchange rate is clear in the sectoral breakdowns of capacity changes, with the largest declines in sectors that had previously seen the largest output swings in response to exchange rate movements (Chart 4). Some of that activity might be lost for good. Newsprint demand will never turn to restore boom times to that segment of the paper industry, and textile and apparel activity will remain challenged by free trade access to goods from low-wage overseas economies.

Even in low C$-sensitive sectors, total capacity has been stagnant, and we have yet to begin undoing the 12% drop seen in productive capacity in sectors sensitive to the exchange rate's earlier overvaluation (Chart 5). In terms of the number of businesses, from 2002, when the C$ was at its lows, to 2012, the country lost roughly a quarter of its manufacturing enterprises.

Chart 5

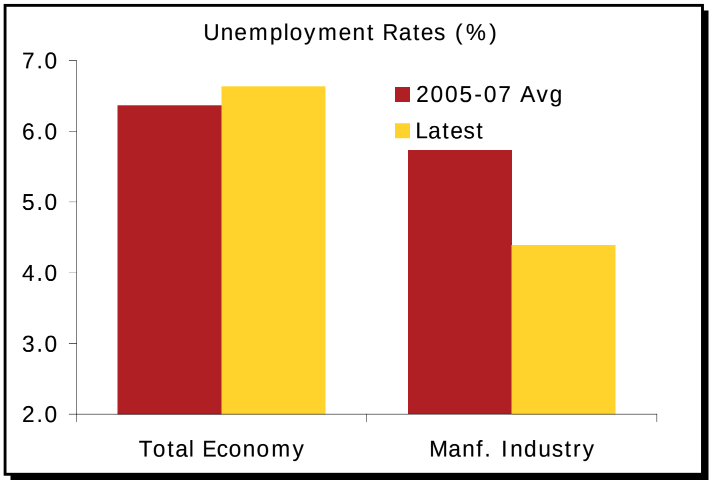
C$-Sensitive Sectors Saw Massive Capacity Drop



Source: Statistics Canada, CIBC

Chart 6

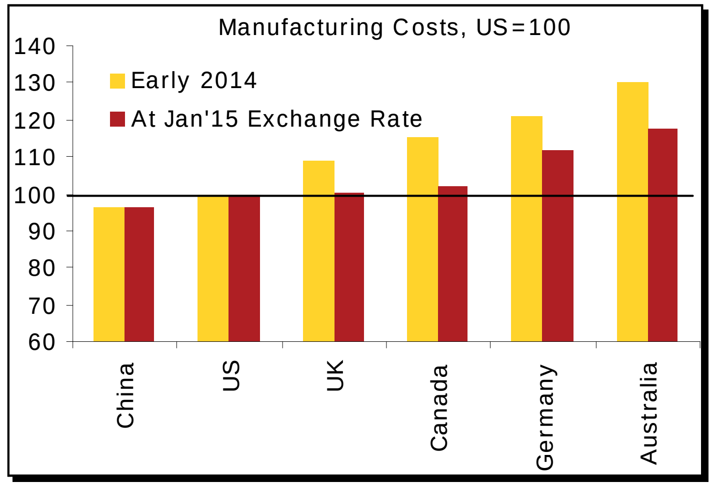
Surprisingly Few Available Factory Job Seekers



Source: Statistics Canada, CIBC

Chart 7

Exchange Rate Shift Improving Canada's Competitiveness



Source: Boston Consulting Group, CIBC

Are the Workers Gone Too?

One might assume that, given a long run of heavy manufacturing job losses, there would be no shortage of experienced workers standing by to meet the industry's needs. But that may not be the case. Unemployment rates by industry actually show a tighter labour market in the factory sector, both in absolute terms and relative to pre-recession conditions, than in the broader economy (Chart 6).

That might not present as much of a true barrier as meets the eye. Average weekly hours in manufacturing are still about 0.5 hours below their pre-recession norm, leaving room to use the existing workforce more intensely.

Since the sector's layoffs have stretched back over the past decade, workers may have in part taken on other, lower-paying jobs, leaving them ripe to be redeployed if factory jobs open up. But it could also capture the aging of the former factory workforce, or its geographic shift to other regions, including the oil patch. If so, further growth in factory output will need investments in human resources—training and education—as well as capital spending.

We Can Win the Beauty Contest

The good news is that it's not just in Canada where spare manufacturing capacity is getting harder to find. US manufacturing capacity use has now also completed a full recovery from its deep recession trough. So as demand continues to grow, at least within the continent, decisions will be coming up soon on new plants or expansions of existing facilities.

In that geographic beauty contest, the current level of the exchange rate, if sustained, should significantly enhance Canada's ability to win its fair share of mandates. A study by Boston Consulting Group published last year showed that, based on an index covering major cost categories, Canada was on average about 15% more expensive in manufacturing costs than the US (Chart 7). But that analysis was based on a 95-cent Canadian dollar. Recalibrated to today's exchange rate, and the gap virtually disappears.

Just last week, however, a senior executive of a major US automaker claimed that "those types of fluctuations" would not impact their plant footprint decisions. That can't be true in the long run; it would imply that relative production costs have no bearing on plant location decisions. Instead, the executive may have been shrugging off the recent move as a "fluctuation" rather than a long term Canadian dollar realignment that will persist over the life of a plant.

Spot exchange rate movements take time before they get worked into the base case assumptions for where the currency will trade over the life of a plant. Expect a lag, then, between new factory investment and our now more competitive exchange rate. As a result, we will need to sustain an 80-85 cent Canadian dollar for several years to come for all of the benefits to show through in our factory sector.