CONFERENCE ON THE SUPPLIER INDUSTRY IN TRANSITION: THE NEW GEOGRAPHY OF AUTO PRODUCTION FEDERAL RESERVE BANK OF CHICAGO-DETROIT BRANCH

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Issues for Carmakers and Parts Suppliers — Challenges for the Seventh District's Auto Industry

Our purpose here today is to analyze the challenges facing the U.S. automobile industry, focusing especially on suppliers. To set the tone, let me take you back to November 2003—the last time we held a special conference on the auto industry. That conference was part of the Chicago Fed's manufacturing assessment project. We met in our former Detroit branch building to discuss the rapid decline of the manufacturing sector in this region.

The main questions then concerned the nature of the downturn. We asked whether manufacturing was at a "crossroads" or merely experiencing a "bump in the road." In other words, were the recent weaknesses in manufacturing attributable to transitory, cyclical factors, such as the worldwide recession and a high-valued dollar? Or did the growth of low-wage economies overseas presage a structural change in which domestic production would migrate overseas at an increasing rate?

Our project paid special attention to the auto sector, an industry that looms large in manufacturing, especially in the Midwest. Much auto production and related activity takes place in Michigan, Indiana, Ohio, and the Canadian province of Ontario. This important industry represents over 3 percent of U.S. GDP and an even higher share of output in the Midwest. Accordingly, structural changes in the automotive industry have a significant impact on this region.

Even then it was clear that if one industry faced a structural turn, it was autos. While overall vehicle sales generally were strong, the traditional Big Three automakers faced serious challenges. And it was clear that the Midwest would continue to be affected by shifts in the regional distribution of motor vehicle production and in the relationships between companies and their suppliers. These relationships need to be put into sharper focus. Automotive suppliers are the lesser known part of the auto sector, even though they employ 3

to 4 times as many workers as assemblers. In addition, supply companies are being asked to play a much more important role in the value chain in such areas as logistics and research and development.

And so, the suppliers are the focus of our conference today. The research that we discuss at this conference will delve deeply into the issues faced by this industry. A strong research understanding—along with the insights of industry leaders—can help all of the participants in the private and public sectors to better fashion plans and policies during these challenging times.

The difficulties of U.S. nameplate automakers and suppliers certainly have been front-page news. The Big Three continue to restructure and cut production capacity amid ongoing losses in market share. Since 1995, the share of the U.S. market held by Chrysler, Ford, and GM has declined from 72 to 56 percent, dropping 7 percentage points over the past 5 years alone. GM reported 2005 losses of $10.6 billion, and the debt of both Ford and GM has been downgraded substantially below investment grade status.

Bankruptcy has become a reality for a number of auto suppliers—more than 20 of the largest 150 have filed for Chapter 11 since 1999, including some of the largest and best known: Delphi, Dana, Tower, and Collins & Aikman.

These bankruptcies reflect a confluence of factors that has created a difficult business environment for many parts suppliers. Such factors include the rising costs of inputs, restructuring of the traditional assembler-supplier relationships, a shrinking customer base, high labor costs, and heightened import competition.

The first of these factors is the large increases we have seen over the past several years in the costs of inputs such as steel, resins, and energy. A good deal of these higher costs reflects the general rise in global demand for industrial commodities. Suppliers' profits suffered to the degree that they were unable to offset cost increases with productivity enhancements or pass them through as higher prices to their customers.

The second factor is that traditional carmaker-supplier relationships are rapidly changing. Today, assembly companies are requiring more from their primary suppliers in terms of product design, engineering, and cost. But some assemblers and suppliers are finding it difficult to achieve the cooperative relationships now required to produce popular, high-quality vehicles.

A third factor is that many suppliers, particularly in the Midwest, are losing business because their Big Three customers continue to lose market share to foreign nameplate manufacturers located in other regions of the United States. The flipside to this, of course, is the opportunity for suppliers to increase sales to the foreign manufacturers who are producing an ever higher number of vehicles in the U.S. But the transition to new customers may be a formidable challenge for many suppliers. New customer relationships take a long time to build, and the costs of relocating operations closer to new customers or servicing these customers from distant production facilities are significant.

The fourth and fifth factors behind the difficult business environment are related. We are all familiar with the issues regarding wage, benefit, and legacy costs in the industry. In turn, these labor costs have contributed to heightened competition from cheaper imported parts. Indeed, direct imports to the U.S. of motor vehicle parts have more than doubled since 1995, increasing from $37 billion to $84 billion in 2005.

And so today we can see with greater clarity that many of the challenges in the auto sector are profound and fundamental, affecting the viability of the manufacturers and parts suppliers as well as the hundreds of thousands of workers employed in the industry.

To be sure, a number of factors affect employment in the industry. Productivity gains in the motor vehicle industry have been strong and steady over the past 20 years. These gains have lowered production costs, which have in turn been passed on as lower vehicle prices to consumers. Productivity gains are also evident from trends in automotive jobs and output. Domestic production of light vehicles changed little between 2001 and 2005, whereas domestic employment declined by 10 percent at final assemblers and by 13 percent—almost 100,000 jobs—at parts suppliers.

In many instances, the structural changes in the motor vehicle industry are affecting the Midwest differently than other auto-producing areas of the country. In response to their large declines in market share, the Big Three have significantly scaled back their operations during the last five years. The Big Three have been modernizing and replacing some of their existing plants in the Midwest, but they have not sited any new ones. In contrast, since 1990, there have been eight new assembly plants built or announced in the U.S. excluding those replacing older facilities in the same metropolitan area. All eight have been built by foreign nameplates, and seven of them are in the South.

The geographic shift in assembly plants impacts parts operations. Parts suppliers tend to concentrate near assembly plants. Prior to 1980, only one out of five supplier plant openings were located in the South. That ratio has now increased to one out of three.

In light of these changes, uncertainty about the automotive industry's future is foremost on the minds of many in the Midwest. As a group, the traditional auto states of Michigan, Indiana, and Ohio have lost 17 percent of their jobs in the motor vehicle and parts industries since 2001. Michigan, the most auto-dependent state in the nation, has lost over 22 percent of its automotive jobs in this period, and its unemployment rate has been among the highest in the country for the past three years. In contrast, outside of these three states, the rest of the country has lost only 6.8 percent of its auto industry jobs.

As these developments play out, the industry and its traditional core region face a painful adjustment. At this conference, we intend to address five important questions that stem from this changing landscape.

First, what is the likelihood of a turnaround for the Big Three assembly companies and their suppliers? While these companies face significant challenges, in earlier periods many troubled firms in the industry have been able to improve productivity and develop new products. And as a nation the U.S. has a long history of refashioning industries with new capital, new organization, and new ideas.

Second, what would be the impact of continued Big Three market losses to the region's automotive parts industry? Can the Midwest automotive parts companies adapt to new customers and markets, and if so, would they move or stay in the Midwest?

Third, how are auto parts companies restructuring their organizational and production processes to put themselves on firmer footing going forward? We have seen and experienced major restructuring in Midwest industries such as steel and machinery. How might the automotive parts industry restructure, and what might it look like after it does?

Fourth, what role will changing management-labor relations, employment costs, and working conditions play in the reconfigured auto parts industry?

And finally, how will all of these changes in the motor vehicle industry affect the Midwest workforce and its communities?

We are going to talk about all of these issues over the next two days. The program is organized in two major sessions. This afternoon we will explore the varied and evolving producer-supplier relationships. We will hear viewpoints from both carmakers and suppliers. Tomorrow our focus will turn to regional developments as they relate to structural changes in this industry. An important component of this discussion is the status of management and labor relations in this industry.