The State of the Domestic Auto Industry: Part II

[Editor's note: These comments by Mark Zandi, chief economist of Moody's Economy.com, are edited excerpts of testimony he gave before the U.S. Senate Banking Committee on December 4, 2008.]

My testimony today focuses on four main points:

1. The federal government should provide financial help to the domestic automakers. Without any help, the automakers will quickly end up in bankruptcy, resulting in liquidations and hundreds of thousands of layoffs at a time when the broader economy is suffering its worst recession since the Great Depression.

2. Under the most likely outlook for the economy and auto industry, the restructuring plans in which the Big Three have requested $34 billion in loans will not be sufficient for them to avoid bankruptcy at some point in the next two years. They would ultimately need $75 billion to $125 billion to avoid this fate.

3. The restructuring plans, if fully executed, could result in a viable long-term domestic auto industry. However, given the very difficult changes this would require of the Big Three and their various stakeholders, there is a considerable risk that they would not be executed effectively. This opinion applies most strongly to GM and Chrysler; Ford appears much more well-positioned to make the necessary changes.

4. I recommend that Congress provide the $34 billion in aid that the Big Three have requested in two tranches in exchange for warrants and restrictions on executive compensation and dividend payments. The first payout should be sufficient to forestall the automakers' imminent disorderly bankruptcy at an extraordinarily fragile time for the economy. The second payout should be made only if the restructuring plans are proceeding successfully. Congress should also at the same time make it clear that if the restructuring plans are unsuccessful, then no more government loans will be forthcoming. Instead, Congress will work to ensure that there is an orderly bankruptcy process by providing financing in bankruptcy and guaranteeing warranties on new vehicles sold.

Point 1: The domestic auto industry needs financial help, and the federal government should provide it.

Without any government help, the Big Three will quickly end up in bankruptcy and be effectively Liquidated, resulting in hundreds of thousands of layoffs at just the wrong time. They would file for Chapter 11, a restructuring, but it would likely turn into a Chapter 7 liquidation. Their factories and other operations would be shut down and their assets sold to pay creditors. Given the collapse in the financial system and resulting credit crunch, debtor in possession, or DIP, financing would be all but impossible to get.

GM appears to be in worse financial shape than Chrysler, which is in much worse shape than Ford. GM is burning through cash quickly and at the current rate could run out of the cash necessary to operate in the next several weeks. Chrysler can avoid bankruptcy longer, but given the poor prospects for vehicle sales and their almost certain loss of market share to the transplants and foreign imports, not much longer. Ford has more financial latitude, but it too would be at significant risk of bankruptcy if GM or Chrysler failed given the disruption to their supply base, dealers and creditors.

That would be very damaging to the sliding economy. The Big Three employ fewer than 250,000 people in the U.S., but given their broad links into the rest of the economy, closer to 2.5 million jobs would be immediately at risk. For every one lost job in auto assembly, another nine jobs are lost at auto suppliers, auto dealers, steel and metal suppliers, plastic and rubber companies, healthcare providers, trucking and freight operators, and others. Hundreds of thousands of people would be laid off at a time when the economy is already set to lose several million jobs. The hit to already-record low consumer and business confidence would be devastating.

Employment Multipliers	
Change in employment due to a 1,000 job change in the auto assembly industry	
Total	9,100
Auto parts manufacturing	1,490
Auto maintenance & repair	940
Wholesale trade	840
Trucking	330
Warehousing	120
Machine shops	100
Foundaries	70
Plastics	70
Nuts & bolts	70
Machinery repair	60
Motor vehicle bodies	50
Glass	50
Steel mills	50
Tires	40
Other Industries	4,820
Sources: Implan, Moody's Economy.com	

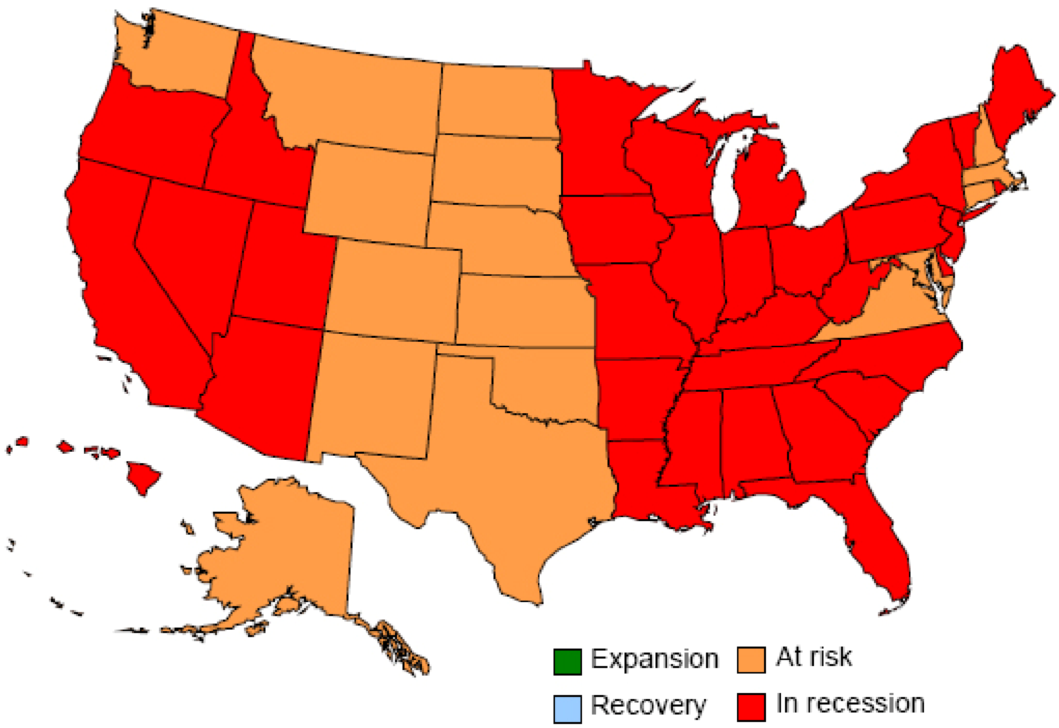
The economic fallout on the industrial Midwest would be disastrous. Michigan and Ohio have been in recession more or less since the beginning of this decade, and the collapse of the Big Three would completely undermine their economies well into the next decade. Indiana, Illinois and Wisconsin would also be hurt. Exacerbating the fallout in the Midwest, unemployed workers would find it difficult to move to perhaps Kentucky, Tennessee or Alabama to work for the stronger transplants. Their home values have fallen so sharply that many are now underwater – they owe more on their homes than they are worth. To move would require that they put more into their home or to default on their mortgages.

Point 2: It would cost the federal government $75 billion to $125 billion to keep the Big Three out of a near-term bankruptcy, much more than the $34 billion they requested.

My $75 billion to $125 billion cost estimate is based in part on the expectation that light vehicle sales will average close to 11 million units in 2009, 13.5 million units in 2010, and less than 15 million units in 2011. For historical context, vehicle sales averaged almost 17 million units annually from 1999 to 2006.

The extraordinarily weak vehicle sales outlook is due to three negative forces: the current sharp decline in employment and surging unemployment, the very severe credit crunch that is undermining the availability of vehicle loans and leases, and the significant amount of spent-up vehicle demand created earlier in the decade as the automakers used increasingly aggressive financial incentives to support vehicle demand. The nation's job market is rapidly weakening. Some 1.2 million net jobs have been lost so far this year, and the unemployment rate has risen by over 2 percentage points to 6.5%. The recent level of unemployment insurance benefit claims suggests that job losses are running at over 300,000 per month. The downturn is broad-based across industries and regions. Sizable job losses are occurring through construction, manufacturing, retailing, transportation and distribution, financial services, and professional and business services. Thirty-three states are now considered to be in recession.

Recession Nearly Everywhere

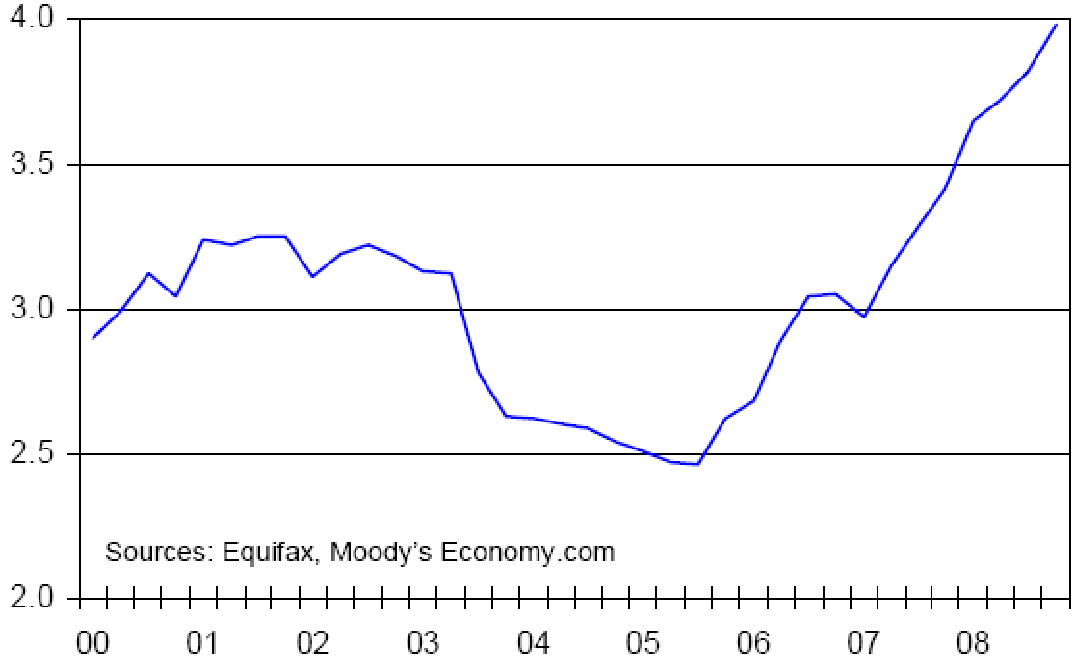


This recession is already extraordinarily long and broad-based and will likely be the most debilitating downturn since the Great Depression. A principal contributing factor is the near collapse of the global financial system and the resulting credit crunch. Credit markets remain badly shaken. Bond issuance has come to a standstill, with no residential and commercial-backed securities issuance in recent months and very little issuance of below-investment-grade corporate bonds and emerging market debt. Asset-backed issuance of credit cards, student loans and vehicle loans has been severely disrupted.

The Treasury Department and the Federal Reserve recently announced plans to establish a lending facility to revive the asset-backed market, but this will take time to effectively implement, and there is no guarantee it will succeed quickly after that. Vehicle lenders are also extraordinarily nervous about the surge in vehicle loan problems; delinquency rates are already at record highs. All of this suggests that potential car buyers will have trouble getting loans or leases well into next year.

Vehicle Loan Delinquency Rates At Record Highs

Delinquency Rates, 30-120 days, $

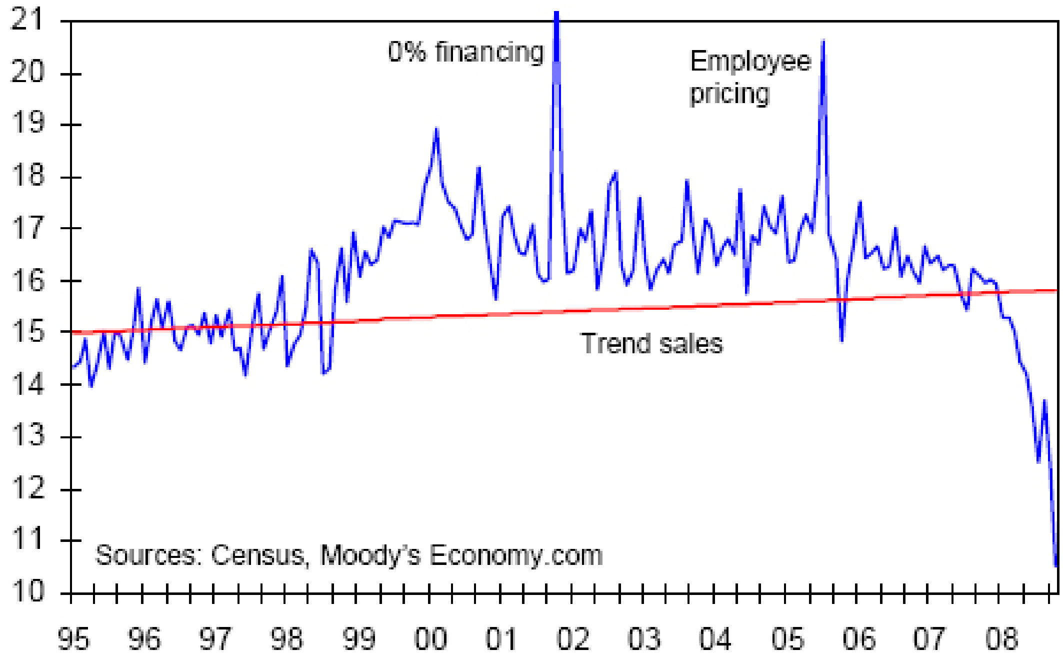


Also weighing on vehicle sales is the large amount of spent-up vehicle demand. Given broad demographic, wealth and income trends, underlying new vehicle sales are at best 16 million units annually The automakers were able to maintain sales of closer to 17 million units during the first half of this decade only by providing increasingly large discounts and easier financing terms. At the peak of the discounting in 2007, the average incentive was worth over $6,000, equal to 25% of the average vehicle price at the time. This is about double the $3,000 in incentives that automakers were giving buyers in 1999. Total spent-up vehicle demand is estimated to be over 10 million units; at the current sales pace, the entire auto industry would have to shut down production for nearly a year to work it all off.

Vehicle sales will eventually return to their underlying annual pace of 16 million units, but only when the job market stabilizes, credit flows more freely, and the spent-up demand is worked off. It could well be two decades or more before sales return to the 17 million unit sales pace that prevailed during the first half of this decade.

The cost of keeping the Big Three out of bankruptcy also significantly depends on their ability to slow the decline in their share of total vehicle sales. Their share has been steadily falling since the mid-1990s from nearly three-quarters of the market to less than half in recent months. This reflects many factors, but most critically higher gasoline prices. Gasoline prices, which had been as low as $1 for a gallon of regular unleaded at the start of this decade soared to over $4 a gallon this past summer. Prices have since receded to below $2 a gallon, but the damage to the Big Three's market share has been done. Even despite lower gasoline prices, vehicle buyers likely still expect higher prices in the future and will not quickly return to buying the Big Three's less fuel-efficient vehicles.

Mounting Vehicle Spent Up Demand
Millions of units, annualized rate



The Big Three's market share will come under even more intense pressure given their financial problems. Potential buyers will fear that their new cars will not be serviced properly and any warranties will become void. Foreign automakers will also step up their efforts to gain market share. Although some of these pressures may be mitigated by government help, they are unlikely to be completely dispelled.

Given the long-running decline in the Big Three's market share, the prospects for higher gasoline prices in the future, and even more intense competition from foreign automakers, it will be very difficult for the Big Three to hold onto to their share of the market. If they are can maintain close to 50% market share, the cost of avoiding near-term bankruptcy will be only $75 billion. If their share falls to 40% over the next two years, however, then the cost will be closer to $125 billion.

Point 3: The restructuring plans put forth by the Big Three are sound in theory, but effectively executing them so that that the automakers become viable companies will be a significant challenge.

Each automaker has outlined dramatic changes to return to long-term profitability, including deep cost-cutting by closing facilities and eliminating more hourly and salaried workers. They also plan to produce more fuel-efficient cars and crossovers, rationalize their brands and retail outlets, and refocus their marketing efforts. All these actions are critical.

It is important to recognize that the automakers have made significant strides. The industry's unit labor costs – labor compensation per unit of output – have actually declined during this decade through 2006. In 2006, unit labor costs fell by nearly 8%. The only other manufacturing industry to experience a larger decline in labor costs was wireless telecommunications. Given the considerable United Auto Workers wage and benefit concessions in 2007, further substantial cost savings could occur over the next several years. The automakers and the UAW have thus shown the willingness and the ability to make significant and difficult changes to become more productive and competitive.

Unit Labor Cost Growth								
Average Annual Percent Change								
Industries ranked based on 2001-06 growth								
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2001-06**
Wireless telecommunications	-10.9	-8.7	-18.0	3.7	2.9	-8.2	-19.8	-7.1
Computer & electronic products	-13.0	4.4	-5.9	-6.5	-12.1	-6.3	-5.0	-6.2
Advertising	-0.1	3.5	-9.2	-4.6	-4.8	6.1	-0.6	-2.6
Motor vehicles	**15.5**	**-0.9**	**-4.0**	**-6.3**	**7.3**	**-2.4**	**-7.6**	**-2.6**
Motor vehicle parts	**2.7**	**0.6**	**-7.0**	**0.9**	**0.2**	**-5.1**	**-1.3**	**-2.4**
Primary metals	3.3	5.3	-4.4	-0.9	-7.1	-1.2	1.7	-2.3
Textile Mill manufacturing	2.0	0.3	-5.9	0.5	-1.8	-7.7	4.4	-2.1
Machinery	-2.6	6.7	-1.6	-1.9	-3.9	-2.5	0.0	-1.9
Transportatioin equip.	11.4	-1.0	-4.3	-1.3	3.8	-4.5	-2.5	-1.7
Chemicals	0.4	4.5	-3.8	0.6	-5.2	0.2	-0.5	-1.7
Textile Prod. Mfg.	-1.7	3.0	-5.0	-1.0	-3.1	-3.1	5.3	-1.4
Retail trade	1.8	-0.4	-2.4	-1.7	-2.3	0.4	-1.2	-1.4
Publishing, excluding internet	4.6	-0.5	-4.0	0.8	-6.1	0.6	4.0	-1.0
Broadcasting	1.7	1.7	0.7	2.5	-4.1	1.5	-4.4	-0.8
Furniture & related products	2.7	2.9	-2.7	-0.6	-1.2	-1.4	1.8	-0.8
Paper	1.4	5.2	-2.9	1.5	-1.4	0.8	-0.6	-0.5
Employment placement	10.9	-3.5	-10.5	-2.3	-6.0	11.1	6.8	-0.5
Apparel manufacturing	-1.4	3.6	4.1	-3.1	5.6	-7.5	-0.9	-0.5
Printing & related activities	1.7	2.0	-1.9	1.8	-1.7	-1.6	1.4	-0.4
Plastic & rubber products	1.9	2.7	-2.0	0.4	-1.6	1.1	1.7	-0.1
Fabricated metal products	-0.3	3.2	-1.2	-0.6	1.7	-1.0	1.1	0.0
Electrical equipment, appliances	-1.8	5.3	1.3	-2.3	0.7	-1.2	1.5	0.0
Wholesale trade	2.2	4.3	-2.4	0.4	-0.9	2.2	2.6	0.4
Nonmetallic minerals	3.2	3.2	-1.1	-0.3	0.4	0.2	3.1	0.4
Miscellaneous manufacturing	-0.8	2.6	5.1	-1.8	0.6	-3.3	2.3	0.5
Cable TV	7.4	3.8	-4.5	-2.6	-4.6	8.2	7.5	0.6
Leather, allied prods.	-4.7	9.0	10.9	-0.8	-2.7	-3.1	1.0	1.0
Food Mfg.	1.7	1.9	1.0	0.6	3.2	-0.3	0.7	1.0
Wood prods.	2.3	2.4	0.3	-1.7	5.6	-1.0	2.1	1.1
Engineering services	1.2	4.9	2.3	2.0	-1.9	-0.8	4.8	1.3
Medical & diagnostic labs	-2.9	0.7	-0.8	0.0	6.6	0.5	0.5	1.4
Food services & drinking places	1.7	2.7	2.4	0.5	2.1	1.8	3.4	2.1
Architectural services	3.5	-0.1	4.1	-6.1	1.5	4.2	7.1	2.1
Accomodations	-1.7	9.0	-0.9	1.7	0.5	6.7	2.5	2.2
Wired telecommunication	9.6	6.0	-7.2	5.7	9.3	0.6	2.8	2.2
Auto repair & maintenance	1.3	3.7	8.4	1.2	-3.3	3.8	2.6	2.6
Amusement & theme parts	3.1	2.4	7.3	0.6	0.0	1.2	3.5	2.6
Banking	2.4	4.5	5.5	6.3	-1.3	8.2	2.3	4.5
Petroleum & coal prods.	-1.3	7.1	6.3	6.8	6.6	8.0	3.0	6.9
Mining	6.0	6.6	-1.3	2.3	12.7	19.1	18.0	12.0
Sources: Bureau of Labor Statistics, Moody's Economy.com								

Despite this clear progress, it will be very difficult for the Big Three to make the even more substantial changes now needed to quickly become viable companies. This is evident in that most of what the Big Three outlined in their restructuring plans had already been announced. There is nothing particularly new in the plans they put forth in part because their current plans are so ambitious and in part because it is difficult to envisage other changes that could be implemented anytime soon.

The most significant new information in the restructuring proposals is GM's plan to cut its debt load roughly in half. This would require significant concessions by GM's debt holders, and it is not at all clear they would be willing to make the necessary compromises, at least on the terms GM is hoping for. Conspicuously missing from the plans is exactly what more the UAW will be required to do. For the Big Three to become viable will require substantially smaller headcounts and other compensation concessions. The UAW can reasonably argue that it has already done a lot, but it is not enough. All stakeholders—management, shareholders, debt holders, the UAW, suppliers and dealers—will be required to quickly make substantial financial compromises to make this all work out. Though possible, this seems unlikely.

Point 4: The federal government should provide the $34 billion in financial aid requested by the Big Three in two tranches. The first payout should be sufficient to forestall an imminent disorderly bankruptcy. The second payout should be provided only if the restructuring plans are proceeding successfully. Congress should also make it clear that no further aid will be forthcoming and prepare to facilitate the orderly bankruptcy of one or more of the automakers.

Given the prospect of an imminent disorderly bankruptcy of GM and possibly Chrysler without quick government aid, and the severe damage this would do to the fragile economy, the government should provide the $34 billion in financing requested by the Big Three. In exchange, the Big Three would provide warrants to the government and agree to limit executive compensation and dividends. Policymakers should provide the money in at least two tranches to ensure the automakers are effectively restructuring.

As previously argued, this aid may very well not be sufficient to return the Big Three to financial viability. Policymakers should thus also make it clear that no more financial help will be forthcoming. Their next step would be to enter into a prearranged bankruptcy. To facilitate a more orderly bankruptcy, the government could promise to provide or guarantee debtor in possession financing. The government guarantee would ensure an orderly restructuring and not liquidation. Bankruptcy would force all stakeholders—management, creditors, suppliers and the unionized workforce—to make the tough choices they have so far been unable to make. It's not that they haven't made strides in lowering labor and material costs and improving productivity, but what is required for the automakers to become viable longer run is too draconian for them to do outside the bankruptcy process.

Even in an orderly bankruptcy, there still would be substantial layoffs. The companies would come out of bankruptcy much smaller, reflecting the much smaller new-car market and their loss of market share. But if this rationalization is done in an orderly way, the job losses should be thousands of jobs per month and not hundreds of thousands. Though painful, this is manageable.

There is a reasonable concern that if the Big Three file for bankruptcy – even a government-supported bankruptcy – people would stop buying their cars. Who wants to buy a car from a company that won't be around to fulfill any warranties or even service it? This is a reasonable concern, but there is no better way to ensure that the Big Three will be around than if they are significantly restructured in bankruptcy. Getting a loan from the government, even as large as $34 billion, won't convince anyone that they will be around for very long without big changes in their operations. To allay some of these concerns, the government could also guarantee warranties on any new cars sold by the Big Three while they are making their way through bankruptcy.

The damage to the financial system of a prearranged bankruptcy should not be significant. The automakers have approximately $100 billion in debt outstanding, and the automakers' captive finance companies have close to $300 billion. Most of the debt is secured, and little is held within the banking system.

Their credit market debt has been rated below investment grade for some time and thus is not held by pension funds and insurance companies but by investors that specialize in distressed debt. The credit default swap market has also already priced in the high likelihood of defaults. Bankruptcy would also send an important signal to any other industry or businesses contemplating asking taxpayers for financial help to get through these difficult times. Most industries don't hold the same importance to the economy as the domestic auto industry, but that won't stop others from asking for help. They may not ask if they know that along with government help would come bankruptcy.

Conclusion

A concerted, comprehensive and consistent government response to the current financial and economic crises is vitally needed. The economy needs a very large and prolonged fiscal stimulus and a large foreclosure mitigation plan, but the government's resources for quelling the crisis are not unlimited and must be used wisely. The federal budget deficit, which topped $450 billion in the just-ended 2008 fiscal year, will easily exceed $1 trillion in the current fiscal year and again in fiscal 2010. Borrowing by the Treasury will be even greater, topping $2 trillion this year. The automakers' pleas for government assistance must be answered, but the answer should ensure that they make fundamental and painful changes. The $34 billion the automakers are requesting will likely not be sufficient to make those changes. Policymakers must be prepared for this very real possibility.