

Is there a case for supporting the auto industry?

by

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In the last several days, the CEOs of the Big Three (General Motors, Chrysler and Ford) have appealed again to the U.S. Senate for \$34 billion in loans or lines of credit. The reason for the Senate negative reaction has to be found in the fact that in late September, Congress already approved a \$25 billion loan for Detroit to finance the development of more fuel-efficient vehicles, which has so far remained on paper.

At the moment, General Motors seems to be most on the verge of a liquidity crisis. At the congressional hearings, GM's Rick Wagoner called attention to plunging car sales as a result of lost confidence and the credit crunch. The generally declining trend in car sales in 2008 plummets most dramatically in the very months when consumer confidence has been at its lowest (June-July and September-October). Chrysler and Ford, although their cash situation is not so dire, support their competitor's plea on the reasoning that if just one of the three goes out of business, there would be an irreversible domino effect across the entire value chain (suppliers, distributors, dealers, repair shops, parts, and workers) of an industry worth 4% of the GDP—which directly employs 240,000 people and generates an estimated 5 million spinoff jobs. According to the Big Three, this is also why Chapter 11 should be avoided: demand would drop even further, as consumers would be unlikely to buy a vehicle from a bankrupt carmaker, given the risks in terms of resale value and the availability of parts and service. This is a position shared by the United Auto Workers union (UAW).

A bailout, even in the form of a temporary bridge loan, is scorned by many economists whose arguments include (i) the folly of supporting bankrupt automakers who produce anachronistic, environmentally unsustainable cars ("so bad for so long," stresses Thomas Friedman); and (ii) the aptness of Chapter 11, which is designed precisely to allow cash-strapped companies to restructure, as noted by Michael Levine. Some other economists point out that what is good for a country may not be good for General Motors (Fogel, Morck and Yeung, 2008).

Today, however, these skeptical positions risk confusing the specific case of GM with the crisis that the entire industry is battling in the U.S. and the rest of the world. This is not the carmaker's "usual" crisis, caused, say, by a drop in demand geared selectively to GM and by a loss of competitiveness, as we saw in the past with competition from Asia. The industry figures speak for themselves.

As of September 2008, all U.S. automakers were down on the previous year, in a market that had shrunk by 23%: GM sales were down about 18%, despite a 27% rise in buying incentives (from \$3,132 to \$3,972 in the space of a year); sales by Toyota, the world leader, were down almost 30% in spite of a 56% increase in average incentive per vehicle; Ford's sales had dropped by 17% and Chrysler's by 25%, although buying incentives had risen from \$3,713 to \$4,705; and Nissan was down by 33%, while Honda showed the smallest decline (1%). U.S. Vehicle sales fell further in November.

Also, if we look at the technology portfolio of General Motors (the company most desperate for cash), we find serious innovation and some true points of excellence, with six hybrid cars in production, two more on the way, and the Chevrolet Volt (E-REV) scheduled to appear in 2010. No fewer than four GM models have been voted Car of the Year.

This is different, then, from the old cyclical slumps that the Big Three have experienced in the past. Whatever we might think of the auto executives who dash to Washington in their

private jets, as Thomas Friedman points out, today's crisis—at least in its short-term manifestation—was probably not caused by Detroit's technological, manufacturing, or organizational shortcomings, but by free-falling demand throughout the industry that started early in 2008 as a result of credit constraints (with car loans taking a sizeable hit) and a drop in U.S. household consumption.

According to data from the Federal Reserve, in 2008 consumer credit growth has slowed with respect to previous years, and quarterly figures for nonrevolving credit are stable. Meanwhile, consumers taking out new car loans have seen interest rates increase whether the loans are from banks or (even more so) from the manufacturers' financing departments, while loans have become shorter in duration and the loan/value ratio has shrunk.

As Attanasio, Goldberg and Kyriazidou have recently argued, changes in interest rates and loan maturities have a major impact, in ordinary times, on various groups of car buyers. Low-income households, for example, will self-adjust their use of consumer credit not as a function of rising interest or discounts (Beltramini and Chapman, 2003), but of shorter loan maturities.

It should also be noted that cars are durable goods and constitute the second-largest asset after the home. Most often, people decide to buy a car to replace one they already own. With U.S. households readjusting consumption, due in part to the credit squeeze, they may obviously decide to keep their old cars a while longer.

Given the above, the crisis appears to be structural on the side of demand, and resorting to Chapter 11 would not fully address the system-wide impact that the drop in demand may have.

Nor does it seem wise to inject the automakers with government funds. It is true: GM has worse liquidity problems than others, due in part to the plunge in income from financial services. However, it is also true that what this crisis teaches us more than others is that cash reserves in this industry are crucial to being able to adapt flexibly when times are tough. But bailing out the corporations, thus helping supply, does not solve the industry's problems—especially if they're caused by demand. Pumping cash into Detroit might prevent immediate bankruptcy, but it in no way guarantees that the crisis will not resurge in a few months if the market fails to take off.

What is really needed are measures that will boost demand, by lowering interest rates for car loans and diluting repayment over a longer period of time. Of course, these measures cannot be fully justified in terms of the public interest (Wells and Orsato, 2005)—despite the argument about protecting jobs in the short term—if the incentive to buy a new car is not matched by a credible plan from producers to replace today's vehicles with lighter ones that are cleaner and consume less fuel.

This type of intervention is in tune with the thinking in Europe, where falling demand appears to be less structural and more dependent on the current economy, especially given the comparatively minor influence of credit constraints. The European Investment Bank is now considering an injection of \$51 billion for the industry, in part to help comply with Kyoto standards. Demand-boosting measures associated with eco-friendly investments and cars can overcome the EU's resistance to government assistance, since environmental, R&D, and job training policies are all legitimate candidates for aid.

This is a time when both Europe and the United States can take measures to ward off crisis in an industry that accounts for a large chunk of GDP, while paving the way for new industrial and consumption models. We have a historic opportunity: to invent measures supporting demand that will not only solve economic problems but help defend the environment as well.

