Trouble down the road

Carmakers are recovering after a terrible year. But daunting long-term problems remain.

Illustration by Peter Schrank

Last December the boss of Fiat, Sergio Marchionne, predicted that the economic crisis would finally force the world's car industry to confront profit-destroying overcapacity and change its broken business model. He also thought that, by the end of 2010, consolidation would result in there being only six high-volume carmakers left in the world. This week, as the industry gathered in Frankfurt, he returned to his theme. But his predictions look increasingly like wishful thinking.

Across the world governments have lavished their ailing car firms with subsidies. Although General Motors (supported with over $50 billion of taxpayers' money) has shed some brands and factories in America, so far not a single carmaker of any size has disappeared. One of the weakest was Chrysler, but thanks to a $7 billion federal bail-out and a deal with none other than Fiat, it motors on. So too does GM's perennially lossmaking former European arm, Opel/Vauxhall, propelled with a €4.5 billion ($6.5 billion) dowry from the German government last week into the arms of Magna, a Canadian auto-parts company, and Russia's Sberbank.

Opel's new owners are threatening to cut some jobs and, perhaps, shut a couple of small factories in Belgium and Britain. But the remarkable thing is that not a single car factory in Europe has closed in the past 12 months. According to industry estimates, overcapacity in Europe next year will be around 7m units, or 30%. In America, a market of similar size, overcapacity will fall from about 6m vehicles this year to 3.5m next year, but a great deal of the overcapacity elsewhere will be aimed at America when sales begin to recover. There is no chance of the gap being filled by rising demand in rich countries: carmakers agree that nearly all their future growth will come from emerging markets, such as China, Brazil and India.

Overcapacity is not the only structural problem confronting the carmakers. The other, potentially just as damaging to profits, is a shift toward smaller and more fuel-efficient cars (see article), caused by three factors. First, cheap credit, especially lease finance, and home-equity withdrawal let people buy more expensive cars in recent years. Without such easy money, they will trade down to smaller models. Second, demographic shifts in rich countries favour smaller vehicles: older people tend not to buy large, powerful cars, which is particularly bad news for Germany's premium carmakers. Third, as governments try to meet their carbon-reduction targets they are tightening emissions standards and penalising vehicles with big engines.

The problem with small cars, from the industry's perspective, is that they are much less profitable. Many carmakers actually lose money on their small cars, but plug the gap with

profits from larger models. As the mix shifts towards smaller models and carmakers have to devote more research spending to developing greener vehicles, profits will suffer. Compounding these long-term worries is the industry's dependence on scrappage schemes, which have boosted demand this year, especially in Europe. Many, if not most, of the sales prompted by government incentives for people to scrap their old cars were to people who would not otherwise have bought a new car. But some were to people who brought purchases forward in order to benefit from the schemes. Just how much this will affect future demand remains unclear.

Put your foot down

All this means that the industry's return to health is by no means assured. Government aid, in the form of bail-outs and scrappage schemes, may have prevented outright collapse, but it has merely delayed the reckoning. Rather than waiting for the crisis to strike once again, the inevitable restructuring will be less painful if it is done during an upswing. The industry needs to get smaller while finding a profitable way to make small, green cars. Mr Marchionne's predictions that the car business will have to close factories to reduce overcapacity on the one hand, and consolidate into a smaller number of big firms to cut costs on the other, may not come true next year. But one way or another, they will come true eventually.

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