The Sky Is *NOT* Falling:

Some Context for the Current World Aluminum Market

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Economic Overview

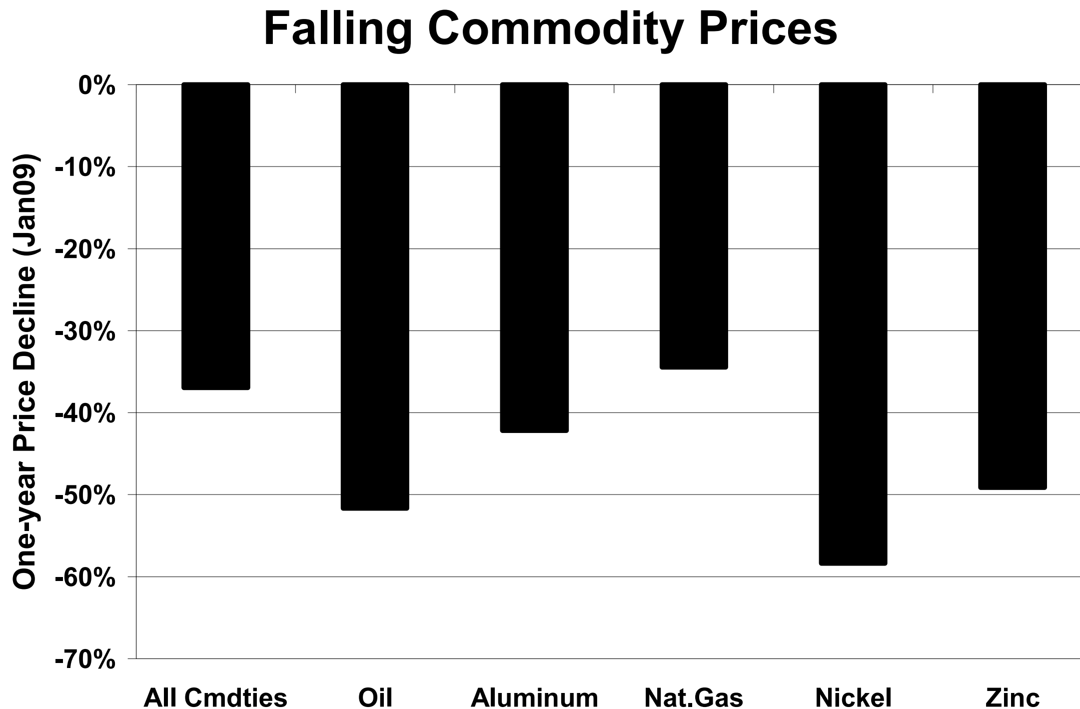
The global economy is entering a challenging recession. This recession was brought on by instability arising from the private financial industry: irresponsible "bets" placed by hedge funds and investment banks on exotic new securities, with hard-to-pronounce names (like Collateralized Debt Obligations and Mortgage Default Swaps), bets which were financed with an unjustified expansion of credit. The failure of those bets has caused a cascade of financial collapses and falling confidence, which in turn has sparked a recession in the "real" economy (that is, the part of the economy that produces real goods and services, as opposed to merely trading in "paper" assets). Canada's economy (measured by our real Gross Domestic Product) will shrink in 2009 by 1-2 percent; the U.S. economy will fare a bit worse. There's no doubt that we are in for a few tough years ahead.

Today the company tries to panic its workers with doomsday scenarios, into accepting givebacks in response to the current, temporary downturn. But its own view of the long-run strength of the aluminum market is undeniably healthy.

World commodity prices have reacted dramatically to the downturn in the economy. Global recession will cause a modest decline in purchases of primary commodities (such as oil, other forms of energy, and minerals). This naturally puts some downward pressure on the prices of those commodities. In the case of the world aluminum market, analysts are currently expecting a decline in consumption of aluminum in 2009 of perhaps 10 percent. This is a significant, but not catastrophic, decline in aluminum sales.

However, the extent of commodity price declines in recent months is far greater than could ever be justified by underlying supply-and-demand conditions in those markets. Prices for most primary commodities (aluminum included) have declined by 30-50 percent in the past year. Prices have declined by far more than actual demand. In the case of aluminum, prices (currently around $1300 US per metric tonne) are 42 percent lower than a year ago (see Figure 1). Some commodity prices have declined further (such as crude oil and zinc); others slightly less. In short, the decline in aluminum prices has not been any better or worse than the generalized decline in commodity prices.

Figure 1



Source: International Monetary Fund database.

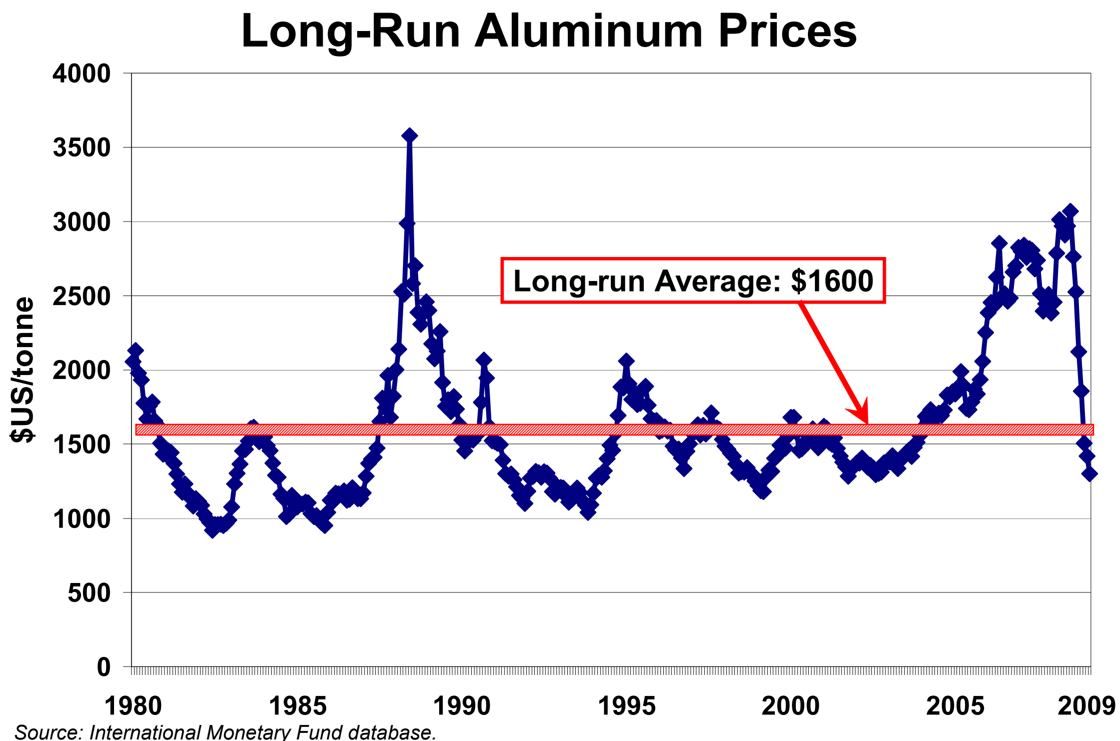
Why do prices for commodities fall so dramatically, when world demand ebbs only slightly? This is because commodities markets are highly volatile, speculative entities, dominated more by the short-term "bets" placed by financiers than by genuine longer-run supply-and-demand trends. The managers of hedge funds and other speculative investment dealers (remember, these are the same folks who caused the global financial crisis in the first place) use commodities futures contracts (for aluminum and other commodities) as another vehicle for placing speculative bets. These inflows of speculative finance helped drive commodities prices to ridiculous, unjustified levels – for a while – when the commodities boom was roaring full-speed (especially in 2007 and 2008). But those same speculators, by pulling their money quickly out of commodities markets at the first sign of trouble, then cause prices to be "oversold" – declining too far, too fast, compared to underlying market fundamentals (which haven't changed that much).

Current aluminum prices are too low, and will certainly rebound. Current prices do not cover the full cost of producing aluminum. In the face of these prices, significant amounts of aluminum capacity around the world (especially older, higher-cost facilities in China and elsewhere) will be closed down. Stockpiles of aluminum are currently growing (since it will take some time for cutbacks in capacity to "catch up" to the modest decline in world aluminum demand). But after coming capacity adjustments, stockpiles will stabilize, and prices will recover somewhat. Then, when the global economy rebounds (most economists expect recovery to begin late in 2009), aluminum demand will start to recover, and prices will rise further.

Aluminum Prices in a Long-Term View

As indicated in Figure 2, the roller-coaster pattern in aluminum prices is nothing new. It is a long-standing, permanent feature of most commodities markets. For the reasons outlined above (especially the speculative impact of hedge funds and other financial players), aluminum prices rise too far, too fast during economic upturns – and come crashing down too far, too fast during the inevitable downturns.

Figure 2



Source: International Monetary Fund database.

It is essential, in making longer-run decisions (regarding investment, capacity, labour contracts, and other business decisions), to keep a long-run focus on the fundamentals of the market, rather than being overly swayed in one direction or the other by day-to-day swings in volatile markets.

Over the last 30 years, aluminum prices have averaged about $1600 US per metric tonne. Spikes in prices are common (especially during periods of economic expansion, when demand can outstrip capacity, stockpiles shrink, and speculators run amok). The price spike of 2006-08 was clearly unjustified and unsustainable, as was the previous dramatic spike in the late 1980s. Business leaders who made long-term, expensive investments assuming that those obvious price spikes could somehow persist, deserve all the misfortune that they subsequently experience.

Similarly, there are many times in the past when aluminum prices dipped below their fundamental long-run averages – often for years at a time. Indeed, there are at least five episodes during the past 30 years when aluminum prices fell far below the $1600 long run average: twice in the 1980s, twice in

the 1990s, and once in the early years of this decade. In other words, for the industry to experience a second episode of below-average prices in this decade is merely "par for the course" (two downturns in prices per decade) and quite consistent with the historical pattern.

Moreover, the price dips experienced in the 1980s and 1990s resulted in aluminum prices that were lower, than has so far been experienced in this current slump (although the aluminum price is likely to fall further in coming months). In other words, there is nothing unprecedented about the current downturn in aluminum prices. It reflects a well-established pattern for this volatile market. Prudent companies would accumulate cash reserves during the years of high prices, in order to stabilize operations during years of low prices. (Of course, Rio Tinto's executives followed a different strategy: namely, spending like drunken sailors during the good years, leaving little to fall back on when aluminum markets predictably and inevitably retrenched.)

The Long-Term Recovery of Aluminum Markets

While current market conditions are certainly gloomy, the fundamental long-run outlook for the world aluminum market remains strong. Aluminum is used more intensively in modern technologies (including replacing steel in many applications thanks to its lighter weight and other features). As lower-income countries (such as China and India) continue to develop (as they certainly will), their use of aluminum will grow rapidly.

What gives the company the nerve to now try to squeeze its workforce even further, on top of these already-planned "synergies"?

In its most recent "chart book" for financial analysts and investors, Rio Tinto itself trumpeted the bullish long-run outlook for aluminum demand. Worldwide demand has been growing at a 5 percent compound annual rate (and much faster than that in China). Demand will temporarily soften during the global recession, but growth will then resume. In fact, Rio Tinto expects world demand to double by 2022, to a total of 66 million tones (see Rio Tinto 2008 Chart book, p. 39). And Rio Tinto has emphasized the fact that aluminum is the most "income-elastic" of all the major base metals: that is, demand for aluminum trends strongly upward as income levels grow (Chart book, p. 37). Rio Tinto's long-term forecast for its own production is equally bullish: almost doubling from about 4 million tones in 2008, to 7 million tones by 2015.

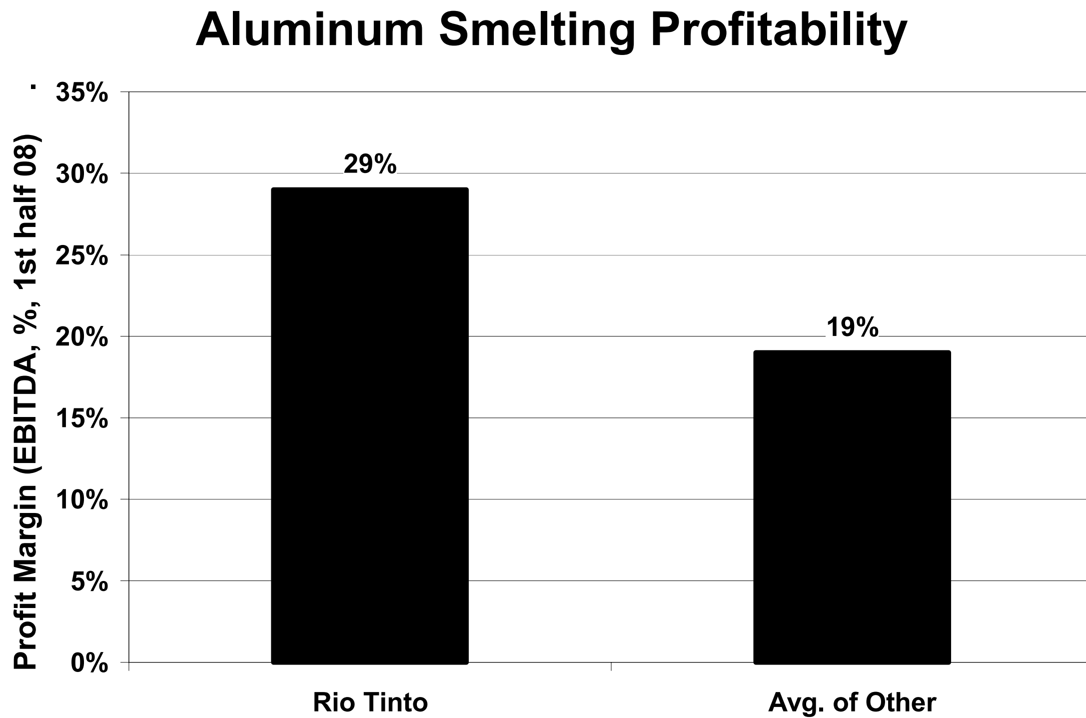
Today the company tries to panic its workers with doomsday scenarios, into accepting givebacks in response to the current, temporary downturn. But its own view of the long-run strength of the aluminum market is undeniably healthy. Yes, the global industry is in for a few tough years. But the roller coaster will inevitably swing back up again, as it has in each previous cycle in the past.

Rio Tinto's Cost Advantages

Canada's abundant hydro resources, advanced technology, and highly productive labour give our facilities a substantial cost advantage compared to older, less productive facilities in other locations. Indeed, Rio Tinto's profit margins on aluminum smelting are substantially higher than those of competing firms. As indicated in Figure 3, it earned a gross profit margin of almost 30 percent on aluminum smelting in the first half of 2008 (most recent data available) – half again higher than the margins enjoyed by its largest competitors. Two-thirds of Rio Tinto's worldwide power use for aluminum smelting consists of hydro power (versus a global average of only 40% for the rest of the industry).

In short, based on its real operations, Rio Tinto should be *better* able than its competitors to withstand the temporary cash constraints arising from the current market downturn. Any problems it is experiencing today, therefore, reflect its excess indebtedness (discussed further below), not any problems in its physical operations.

Figure 3



Source: Rio Tinto Chartbook 2008, p.10.

Moreover, Rio Tinto has reported to financial analysts that the company is ahead of schedule in reaping planned operational cost savings (or "synergies") from its merger with Alcan. It expects to attain $1.1 billion per year in savings by the end of 2009 (Chart book, p. 52). It is already reaping substantial savings from its takeover of Alcan. What gives the company the nerve to now try to squeeze its workforce even further, on top of these already-planned "synergies"?

What's the Real Problem?

The reason Rio Tinto is so desperately trying to cut costs in its Canadian operations is not truly because of the downturn in global markets. Rather, the company entered this recession dramatically overburdened with debt – the result of an acquisitions spree during the years that preceded the crash.

This debt load, taken on as Rio Tinto's executives rushed to expand when aluminum prices were sky-high, now drags down the whole company. So executives are attempting to pass the buck to the workers.

In its final financial reports before being absorbed by Rio Tinto (for the third quarter of 2007), Alcan reported a very strong balance sheet. It had almost $13 billion in shareholder equity, compared to just over $5 billion in debt. It had, in other words, 42 cents in debt for each dollar in equity.

At the end of 2008, in contrast, Rio Tinto reported almost $40 billion in debt (much of which was taken on to finance the Alcan takeover at vastly inflated prices), and only $22 billion in equity. The company carries $1.77 in debt for each dollar in equity. It is, therefore, ***four times*** as indebted (by this key measure) as Alcan was.

One reason Rio Tinto's balance sheet looks weak today is because its own analysts now admit the company paid about $8 billion too much for Alcan (in light of aluminum prices today). So the company took a massive one-time write-down at the end of 2008 to account for that overpayment. Rio Tinto's underlying profits were fabulous in 2008 (exceeding $10 billion U.S., a fantastic profit for any company). But its actual net income, after adjusting for the Alcan overpayment, was more modest: "only" $3.7 billion.

It is worth noting that Rio Tinto's executives remain committed to paying out a generous dividend (currently set at $1.36 US per share) to its shareholders, despite its excess debt and looming financial challenges. Shouldn't shareholders be the first ones to pay the price for the over ambitions of management – not the workers?

To be sure, whenever commodity prices fall, corporate executives try to take it out on the workers, and Alcan was no different. Even if Alcan had not been bought out, there is no doubt that executives would be coming to the workers today to plead poverty and demand givebacks. But Rio Tinto's irresponsible buying spree, and the crushing debt load that is the legacy of its over expansion, is spurring this company to be more desperate, and more mean-spirited, in its demands on the workforce.

It wasn't Canadian workers who spent $37 billion on a fly-by-night takeover of Canada's major aluminum producer. It was Rio Tinto's profit-hungry executives. So why should Canadian workers pay the price, now that the deal has turned sour?

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Rio Tinto's Survival Plan

Rio Tinto's executives have taken emergency measures in an effort to meet its inflated debt obligations and survive the current downturn. It has sold off several assets to raise cash to pay its debts, and postponed investment projects (including in Kitimat) to conserve cash until market conditions recover. It has also welcomed a massive new $19.5 billion investment from China's aluminum company, Chinalco (which will now become a major owner, indirectly, of Canadian aluminum assets – a worrisome development which Investment Canada has utterly failed to monitor or regulate). The company's brand-new chairman resigned in protest over this sell-off to the Chinese.

Rio Tinto will survive both the current market downturn and the destructive mismanagement of its executives in recent years. And the aluminum and hydropower, which is the ultimate source of this company's profits, are not going to "rot": the alumina will still be there, and the rivers will keep running.

Neither the workers, nor the other stakeholders in the aluminum industry (including the citizens of jurisdictions like B.C. which have granted lucrative hydro rights to the company), should be frightened or browbeaten by this company's desperate demands. We must force Rio Tinto, which reaped tens of billions of dollars in profits in the incredible five years ending in 2008, to live up to its obligations, including the obligations which are embodied in its collective agreement with the CAW.

Conclusions and Implications for Local Work Practices

Rio Tinto officials, invoking a doomsday scenario about the company's finances, are trying to extract concessions from workers in all its worldwide operations on wages, benefits, and work practices. We must take a longer-term view of this company and our industry. Aluminum markets will recover. Rio Tinto's own documents highlight the fact that aluminum is the metal of "choice" for countries (like China and India) that will experience rising income levels in the decades ahead.

We will need to hold firm against panicked company demands for givebacks in many areas. For example, the company has relied increasingly on overtime in its Kitimat operations, as a way of trying to suppress headcounts and associated benefit and pension expenses. Overtime intensity rose every year between 2004 and 2008, almost doubling (from 9% to 16% of hours by 2008). The 388,000 hours of overtime worked in 2008 could translate into as many as 185 new positions if the company lived up to its responsibility to adequately staff its operations and smooth out the workload. This need not incur additional labour expenses, either, since the costs of new hiring are offset by improved productivity, improved attendance, and reduced overtime penalties.

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In summary, Canada's mining and smelting industry, and Canada's hard-working employees in that sector, have been through economic cycles like this one before. Yes, it is true that prices are low, and companies will lose money for a while. This is merely the flip side of the ridiculous profits these companies raked in so recently. We refuse to allow our jobs, our collective agreements, and our entire communities to be turned upside down by temporary, predictable cycles in over-volatile commodities markets. We are especially unwilling to make additional, needless sacrifices, when the company's problems are so clearly the result of irresponsible over expansion during the last great upswing.

Jim Stanford is an economist in the research department of the Canadian Auto Workers, Canada's largest private-sector trade union. He received his PhD in economics in 1995 from the New School for Social Research in New York. He also holds economics degrees from Cambridge University in the U.K. (1986) and the University of Calgary (1984). Mr. Stanford is the author of *Paper Boom* and co-editor, with Leah F. Vosko, of *Challenging the Market: The Struggle to Regulate Work and Income.* He is the author of *Paper Boom* published in 1999 by the Canadian Centre for Policy Alternatives and James Lorimer & Company. Mr. Stanford's column on economics appears every other Monday in the Globe and Mail.