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Commentary

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Weak Business Investment, Household and Public Debt Constrain Canada's Economic Recovery

Philip Cross

Economic recovery continues, but business investment is weak and household and public debt remain too high.

Highlights

Canada's economy continues its recovery following from the crash in oil prices in 2014, but remains plagued by shortfalls in business investment and worrisome trends in household and public debt.

The energy sector has experienced a small rebound, reflecting a 10 percent increase in spending on conventional oil and gas. Even with the drop in oil prices, energy investments remain relatively stable and account for 45.7 percent of all business investment, leaving it the focal point of capital spending and the prime determinant of our future industrial structure. In contrast, investment in other industries showed widespread weakness.

Investment in manufacturing in Canada has proven particularly poor, with intentions falling 4.6 percent in 2017 to $15.2 billion. Ontario has faced the brunt of this malaise, especially in the auto industry. For instance, capital spending there has fallen from over $3 billion a year before the recession to $2 billion in recent years. Meanwhile, manufacturing investment in every province outside of Ontario had regained its pre-recession peak.

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The housing market in some parts of the country continue to be strong. Prices for existing homes in the Toronto area rose by about 30 percent in the year ending in February. Even in Vancouver, where various measures have cooled demand by 42 percent from a year ago, prices only fell by 3 percent. Households continued to borrow over $40 billion (at annual rates) from the rest of the economy.

More uncertain is whether the housing market increase has had a beneficial impact on consumer spending. Consumer spending in general, apart from the housing sector, remained restrained. Instead of spending more, strapped households used money from the federal government's Canada Child Benefit to boost their saving rate, from 4.9 percent in the first half to 5.7 percent in the second half.

Employment growth in Canada picked up to 0.6 percent. But this is fuelled primarily by the public sector, which was the fastest growing industry in Canada in 2016. Governments also continued to rely on debt to finance their spending. Federal borrowing rose to $23.2 billion in the fourth quarter, while provincial borrowing increased to $28.4 billion.

Fundamentally, while year-on-year growth has largely returned to pre-oil price crash levels, Canada's economy continues to be overly reliant on growth being provided by household and government, which remain heavily in-debted, rather than business investment and exports.

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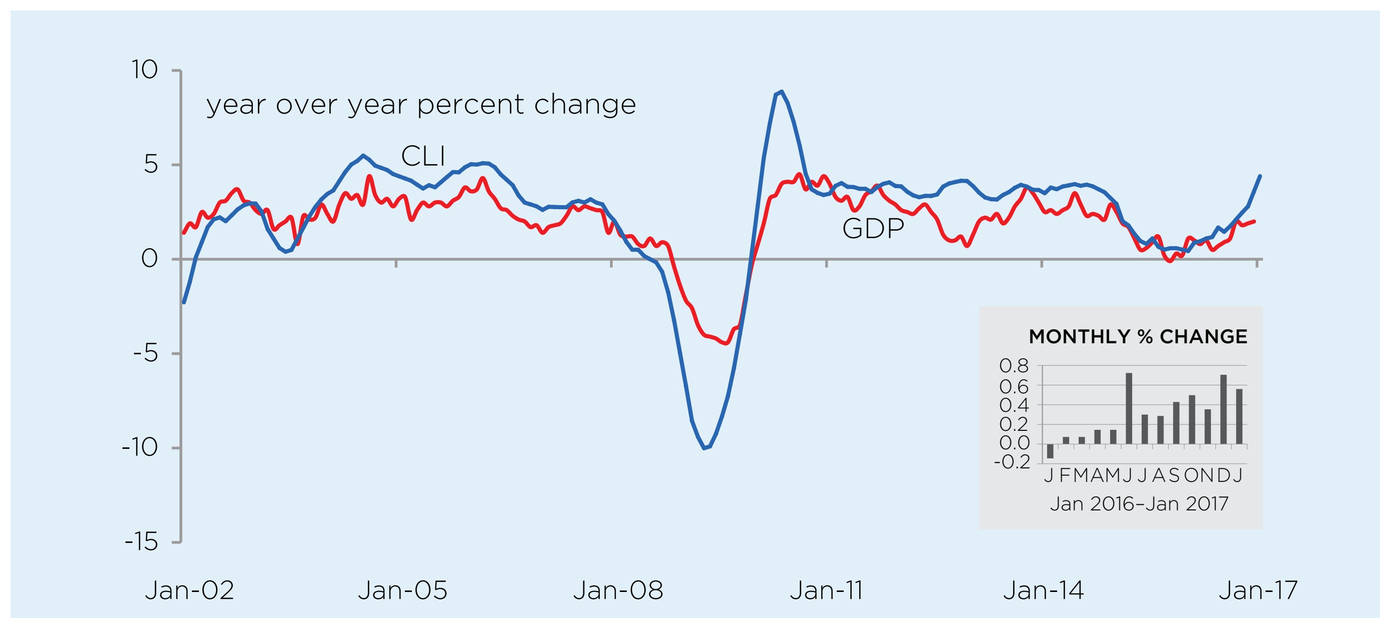
Overview

The Canadian economy continued to recover in the second half of the year, following a weak first half, with real GDP increasing by 0.6 percent in the fourth quarter after a 0.7 percent gain in the third when recovery began from the wildfires in Alberta. Employment growth also picked up to 0.6 percent, fuelled by growth in the public sector. However, the transition from a reliance on household and government spending to exports and business investment remains elusive. Exports edged up only 0.3 percent in the quarter and 0.8 percent in the past year, while business investment fell 2.1 percent. The outlook for business investment remains clouded, as the annual Statistics Canada survey of investment intentions found firms plan to cut capital spending by 5.6 percent, its fourth straight decline. As a result, the Bank of Canada characterized the economy as demonstrating "persistent economic slack" (Bank of Canada 2017).

A pick-up in the Macdonald-Laurier Institute Leading Economic Indicator to 0.6 percent growth, from almost no growth early in 2016, reflects a recovery to the 2 percent rate of economic growth rate that was posted before the oil price shock pushed growth below 1 percent at its nadir (see figure 1). Indeed, the year-over-year growth of real GDP returned to 1.9 percent by the fourth quarter, exactly the same as the United States. However, despite an improving outlook for the US economy, there are few signs that the hoped-for breakthrough to growth rates of 3 percent or more is in the offing.

Figure 1: MLI Leading Economic Indicator, 2002-2017



The failure of the Bank of Canada to enable Canada's growth to transition to exports and business investment is important because of Canada's indebtedness. The recent gains in household spending and government have been fuelled by borrowing. The hoped-for gains in exports and business investment would have reduced Canada's reliance on debt to fuel growth. Instead, continuing to rely on debt-fuelled increases in housing and government spending means the Bank of Canada cannot follow the US in beginning to normalize interest rates.

Business Investment Continues to Fall in 2017

Business firms plan to cut nominal investment spending by 5.6 percent in 2017,[1] the fourth straight annual decline. However, unlike the three previous declines, the planned drop for 2017 does not primarily reflect weakness in the energy sector. Investment intentions for the energy sector edged up slightly, after falling by a cumulative 36.4 percent over the previous three years. Instead, investment was pulled down by widespread weakness in most other industries, with cuts planned in 10 of the 13 major industry groups. Mining, manufacturing, transportation (excluding government investments in urban transit), retailing, and banking all plan important declines. The only gains were in utilities, real estate, and telecommunications.

The small rebound in the energy sector reflects a recovery of almost 10 percent in spending on exploration and development and conventional oil and gas extraction. By contrast, investment in the oil sands is scheduled to fall to its lowest level since 2005. The shift from the oil sands to conventional oil and gas reflects the lower capital costs of conventional projects and greater flexibility to curtail these operations if the recent rally in oil prices based on OPEC (Organization of the Petroleum Exporting Countries) respecting its production quotas does not hold.

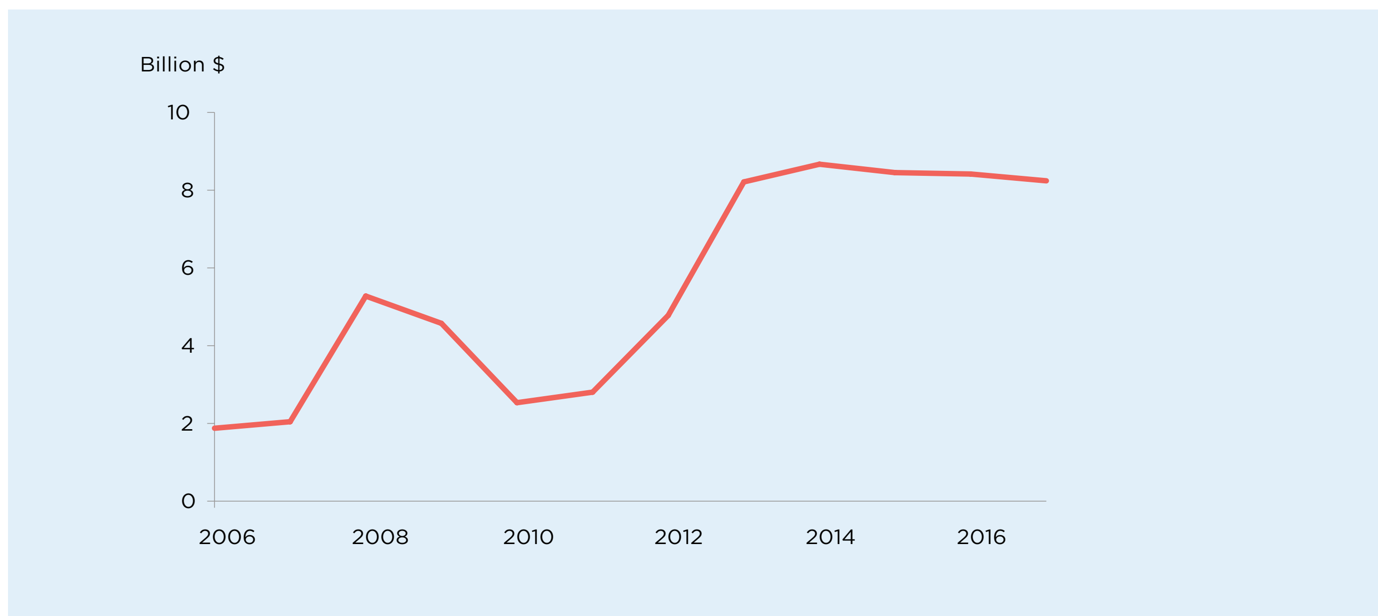
The inflexibility of oil sands operations was reflected in the different trends of output and investment since the oil price collapse began late in 2014. Initially, investment in the oil sands was not cut as fast as conventional oil and gas, reflecting how firms were committed to finishing projects already undertaken and nearing completion.

As a result, output of crude oil from the oil sands continued to increase into 2016, with further increases to come this year and next. Meanwhile, investment in the oil sands will fall to $12.0 billion in 2017, two-thirds below its peak in 2014. With no new projects starting this year and investment falling rapidly, the oil sands will have taken three years to feel the full impact of the price downturn. The conventional oil industry began to bear the negative impact on both output and investment immediately in 2015, but is now poised to begin to recover if oil prices are sustained at their current level of about $50 (US) a barrel.

Overall, the bust in oil and gas prices has slightly reduced the orientation of Canada's business investment to energy since 2014. The share of the energy industries in business investment peaked at 54.7 percent in 2014. In 2017, energy still accounts for 45.7 percent of all business investment, leaving it the focal point of capital spending and the prime determinant of our future industrial structure.

The relative stability of energy investment since 2014, even with the drop in oil prices, reflects a number of factors. Despite the cutbacks in oil and gas spending, investment in this sector remains at historically high levels; outlays of $36.4 billion in 2017 are close to the $41.3 billion spent in 2007, just before the peak of the previous boom in oil prices in 2008. As well, investment in pipelines has quadrupled since 2006, from $2.0 billion to over $8.0 billion in every year since 2014 (see figure 2). While much attention was focused on the difficulty in getting approval of pipelines to tidewater and the Obama administration's obstinate refusal to approve the Keystone pipeline, it has been overlooked how much new pipeline was laid within Canada to carry the large amount of new oil and gas capacity being added in Alberta, British Columbia, and Saskatchewan. Finally, energy investment was sustained by stability in utilities, which have risen slowly every year since 2014 to reach $33.0 billion in 2017.

Figure 2: Capital expenditures on pipelines, 2006-2016



Source: Statistics Canada CANSIM table 029-0046

Investment outside of energy is now the major source of weakness. Investment in manufacturing in Canada continues to languish, with intentions falling 4.6 percent in 2017 to $15.2 billion. This is below the $15.8 billion invested in 2013, when the exchange rate was still at parity with the US dollar. The reluctance to invest in

factories in Canada has been persistent and widespread. From 2013 to 2017, investment has fallen in 11 of the 18 industries for which data is available. This implies that the failure of manufacturing to respond as vigorously as the Bank of Canada expected to the lower dollar is much more than the legacy of plant closures – for which there is scant evidence (Cross 2016). It reflects an unwillingness of firms to invest in factories in Canada despite the alleged attraction of a devalued currency. The benefits of such a situation to manufacturers are negligible after they had spent years restructuring their operations to use more imported inputs on the assumption the dollar would remain high. Even export industries that use energy intensively (and therefore should be profiting from both low oil prices and a devalued exchange rate) cut investment spending, including chemicals, primary metals, paper, and petroleum refining.

So why is manufacturing investment so unresponsive to the lower dollar and cheap oil prices? Much of the answer lies in the provincial distribution of the weakness. Historically, Ontario is host to nearly half of all manufacturing investment in Canada. However, manufacturers in Ontario have curtailed investment in recent years, averaging outlays of $6.2 billion since the dollar began falling in 2014. This is 23 percent below its average of $8.0 billion a year from 2006 to 2008 (provincial investment data only go back to 2006), despite the rapid appreciation of the exchange rate during that period.

> "From 2013 to 2017, investment has fallen in 11 of the 18 industries for which data is available."

The slump in manufacturing investment in Ontario is widespread. The largest shortfall compared with the pre-recession period of 2006-2008 was in transportation equipment, which in Ontario is dominated by the auto industry. Capital spending by the auto industry has fallen from over $3 billion a year before the recession to $2 billion in recent years. While important and high-profile investments in retooling auto plants were made in 2014 and 2015, there has been no greenfield investment in building a new auto plant since 2008. However, the malaise in Ontario's factories extends far beyond the auto industry. Investment has not recovered to its pre-recession levels in wood, chemicals, machinery, furniture, computers and electronics, non-metallic minerals, and rubber and plastics. Many of these industries are energy-intensive, suggesting the high cost of electricity for industrial users is one factor hampering investment in Ontario's factories.

Meanwhile, manufacturing investment in every province outside of Ontario had regained its pre-recession peak during the recovery. Provincial investment data can be easily skewed by one or two large projects. For instance, manufacturing investment in Quebec was boosted in recent years by a heavily-subsidized cement plant in Gaspe, while investment in British Columbia slowed after Rio Tinto finished upgrading its aluminum smelter in Kitimat in 2015. Yet the results do suggest that firms are willing to invest in factories in most of Canada, but not in its industrial heartland. Next door in Quebec, investment intentions in manufacturing have strengthened over the same periods, from $3.3 billion to $3.7 billion. Much more than a lower dollar will be needed to lure investment into Ontario given the high costs of taxes, electricity, and regulation to operate in that province.

Financial data show that corporations in Canada are beginning to repair their balance sheets, a necessary development before they can resume investing. After borrowing for most of the last two years, firms were net lenders to the rest of the economy at an annual rate of $34.6 billion, the most since early 2012. Higher profitability as oil prices improved and lower capital spending reduced borrowing requirements.

Toronto Home Prices Continue to Soar

While business investment in Canada continues to slump, the housing market in some parts of the country remains effervescent. Prices for existing homes in the Toronto area rose by about 30 percent in the year ending in February, implying a doubling of prices every two and a half years. Meanwhile, the various measures taken by the federal, provincial, and local governments cooled demand for homes in Vancouver by 42 percent from a year ago, although prices fell by only 3 percent.

Central banks disagree about the possible effect inflated housing values have on the economy. Mervyn King, former Governor of the Bank of England, recounts how the Bank of England and the US Federal Reserve Board reached different conclusions on the impact of rising house values before 2008 on consumer spending (King 2016). The Federal Reserve models held that the increased wealth effect boosted consumer spending. In contrast, the Bank of England maintained that since incomes are not affected by higher house prices, the impact on personal spending would be negligible unless households generated funds by moving into a smaller house or borrowing against the higher value of the house. The tepid growth of nominal retail sales in Ontario (up 4.2 percent in the year to December, slightly below the national average) suggests Ontario's housing boom is not being used extensively to finance more consumer spending.

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Households and Governments Borrow to Finance Spending

Households continued to borrow over $40 billion (at annual rates) from the rest of the economy. However, the data on the role of debt in fuelling the Canadian housing market may be understated. The experience of British Columbia suggests that non-resident buying played a significant role in fuelling the rapid increase in house prices. However, only borrowing in Canada by these non-residents is captured in the data on household debt. Borrowing done in overseas countries that is then transferred to Canada to make a house purchase is not included in debt statistics for Canada. While overseas loans to non-residents pose no direct default risk to the Canadian financial system, a downturn in home prices in Canada could induce overseas lenders to force non-resident homeowners in Canada to sell, putting more downward pressure on prices. Another unofficial but important source of financing, especially in Vancouver and Toronto where few millennials on their own can afford average prices approaching $1 million, is the so-called "Bank of mom and dad." Again, almost no data exists on the extent of these intra-family transfers or loans.

Outside of housing, consumer spending remained restrained. Despite the injection of $4 billion from the federal government's Canada Child Benefit in the second half of the year, consumer spending slowed from an increase of 1.4 percent in the first half to 1.0 percent in the second half. Instead of spending more, strapped households used the government money to boost their saving rate, from 4.9 percent in the first half to 5.7 percent in the second half.

The public sector (defined as public administration, health care, and education) was the fastest growing industry in Canada in 2016. Governments continued to increase their reliance on debt to finance their spending. Net borrowing reached an annual rate of $46.3 billion in the fourth quarter. The federal shortfall continued to grow; after running a surplus as recently as the first half of 2015, its net borrowing rose to $23.2 billion in the fourth quarter. Meanwhile, provincial borrowing resumed its upward trend, rising to $28.4 billion.

Conclusion

The worst of the effects for the Canadian economy from the crash in oil prices have largely passed. As a result, year-over-year growth has almost returned to 2 percent, about where it was before the oil price shock. However, growth remains dependent on households and governments, which remain heavily-indebted. Despite the lower dollar, exports have risen by less than 1 percent in the past year, while business investment continues to recede with no upturn in sight for 2017.

The weakness in exports and business investment are related. Despite a surge in crude oil export volumes as oil sands projects came on line in 2016, exports were held back by declines for a wide range of manufactured goods. In turn, the persistent weakness in business investment can no longer be attributed to energy, as the oil and gas sector shows signs of reviving in 2017. Instead, the slump in investment is increasingly the result of a malaise in Canada's manufacturing sector, the very sector the devaluation of the dollar from parity with the US in 2014 was designed to stimulate. While manufacturing investment had recovered to pre-recession levels in most provinces, Ontario is clearly the source of the persistent unwillingness of manufacturers to invest.

About the Author

Philip Cross is a Munk Senior Fellow at the Macdonald-Laurier Institute. Prior to joining MLI, Mr. Cross spent 36 years at Statistics Canada specializing in macroeconomics. He was appointed Chief Economic Analyst in 2008 and was responsible for ensuring quality and coherency of all major economic statistics. During his career, he also wrote the "Current Economic Conditions" section of the Canadian Economic Observer, which provides Statistics Canada's view of the economy. He is a frequent commentator on the economy and interpreter of Statistics Canada reports for the media and general public. He is also a member of the CD Howe Business Cycle Dating Committee.

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Endnote

1 The business sector excludes investment made by the public administration, health care, education and urban transit industries (Statistics Canada 2017).

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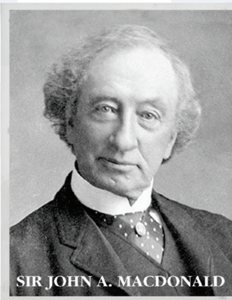
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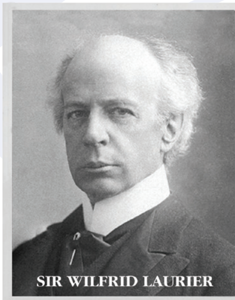
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