A Macdonald-Laurier Institute Publication

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True North in Canadian public policy

Commentary

JULY 2019

Tepid Economic Growth in Canada Points to Structural Problems

Canada's economy remains hampered by deficit-fuelled spending and continued weakness in investment and exports.

Philip Cross

Overview

Canada's economy is continuing its trend of miniscule growth. Tepid economic growth in Canada is in marked contrast with much faster growth in the US, where over the last four quarters real GDP in the US rose 3.2 percent versus 1.3 percent in Canada. This is largely due to the unique buoyancy of business investment in the US.

The Macdonald-Laurier Institute's leading economic indicator (LEI) points to a resumption of moderate growth over the remainder of the year. However, growth in Canada has failed to make the transition from deficit-fuelled spending by governments and households to business investment and exports.

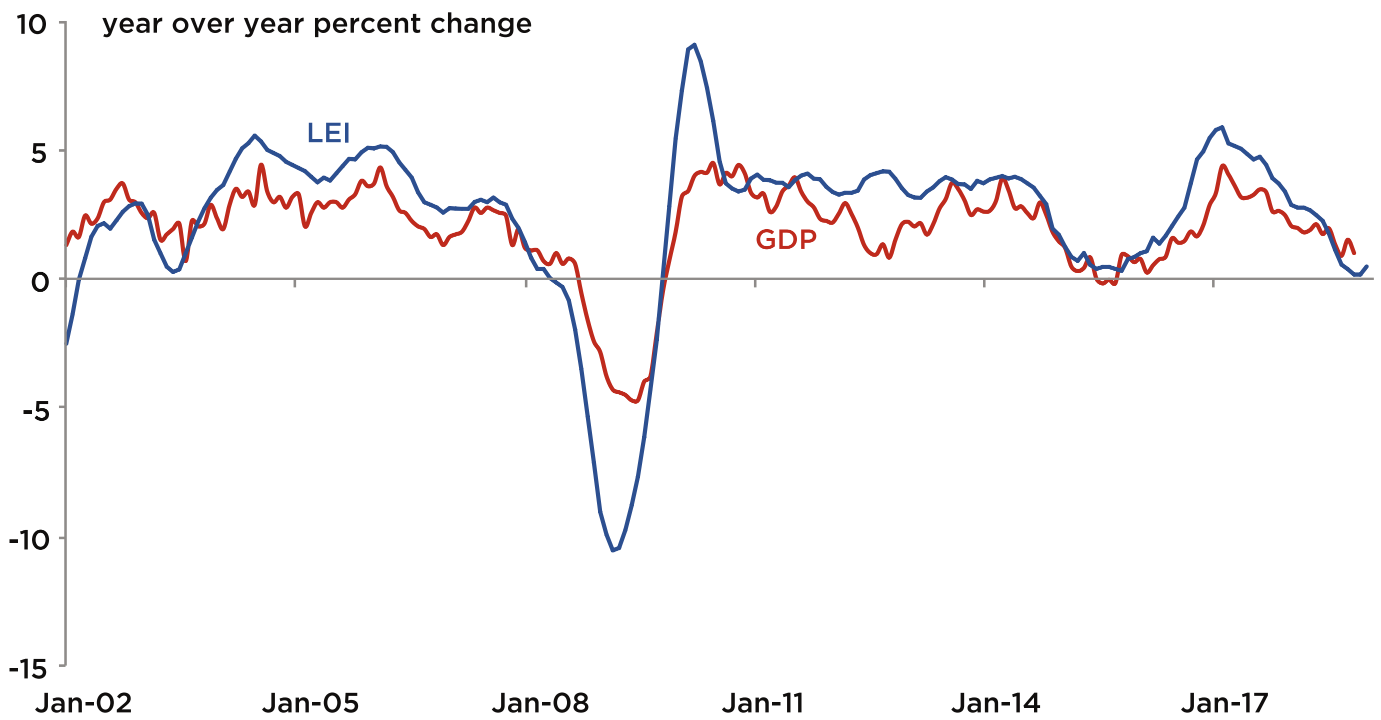
Business investment has been lacklustre since 2008, while the slump in exports arises from both cutbacks in oil production and a consistent weakness in non-energy exports. This weakness of investment and exports are interconnected, reflecting structural problems with Canada's productivity and competitiveness. Housing has continued to retreat for a fifth consecutive quarter. While consumer spending has rebounded, this upturn was financed by higher debt and lower savings; real incomes remain weak.

Introduction

Economic growth continued at an anaemic pace in the first quarter, with real GDP edging up 0.1 percent for the second consecutive quarter. All of the growth originated in the government sector, as GDP generated by the business sector fell 0.1 percent in each of the past two quarters.

The stall in the Canadian economy over the last six months was predicted by the Macdonald-Laurier Institute leading economic indicator (LEI), whose growth slowed to a crawl last spring. The resumption of growth in the leading index with a 0.4 percent gain in April suggests that this stall will end soon with growth resuming at a moderate pace (all data as of June 27). The ten components of the index were evenly divided by increases and decreases, a reminder of lingering weakness in important sectors of the economy. The 0.5 percent gain in GDP in March, while not enough to materially affect the first-quarter results, leaves the economy well-positioned for a meaningful gain in the second quarter.

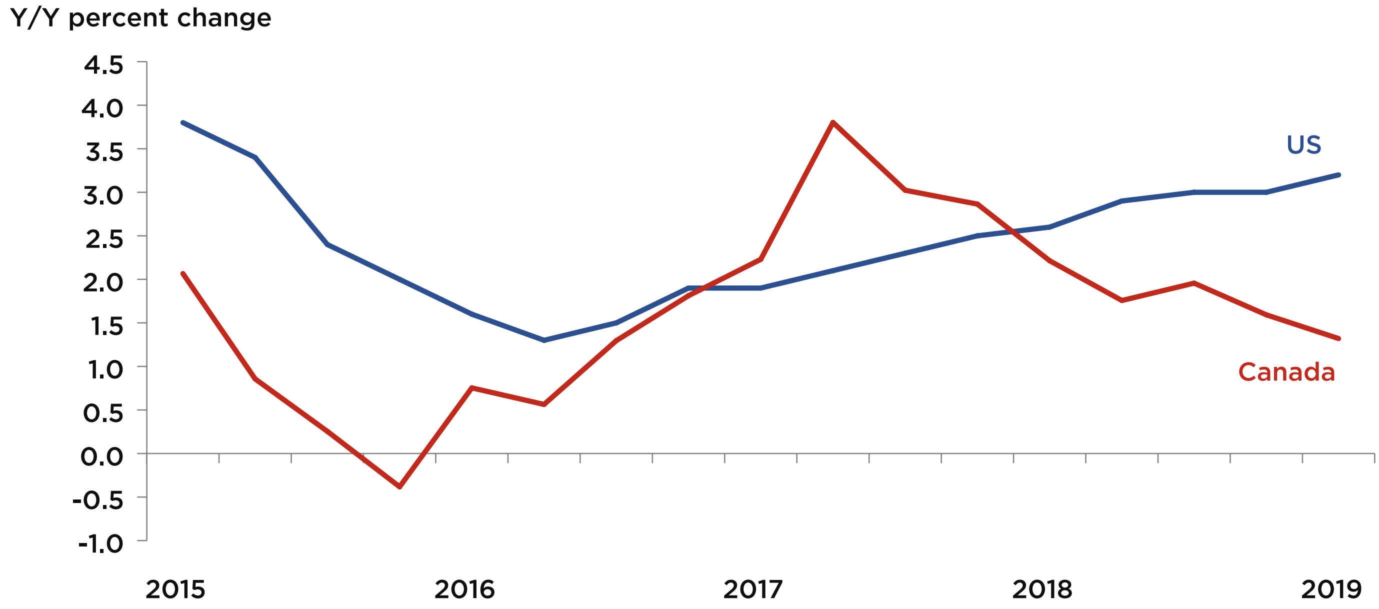
MLI'S LEADING ECONOMIC INDICATOR (LEI)



Canada's growth lags far behind the US

The weakness in Canada's economy is in stark contrast with the United States. Over the past four quarters, real GDP in the US rose 3.2 percent versus 1.3 percent in Canada. Business sector GDP in the US expanded even faster at 3.9 percent, its strongest annual increase in years. By comparison, business sector GDP in Canada rose by only 0.9 percent over the past four quarters.

REAL GROSS DOMESTIC PRODUCT, UNITED STATES AND CANADA



Source: U.S. Bureau of Economic Analysis, CANSIM Table 36-10-01014-01

Nearing the 4 percent growth threshold in the US business sector is significant for a number of reasons. It belies the notion that chronically slow growth is the "new normal." Instead, the US demonstrates that a judicious mix of policies both supporting aggregate demand and encouraging the supply of investment produces better results than the exclusive focus on demand management that has dominated policy-making in most countries over the past decade. The reassertion of "American exceptionalism," where US growth clearly outstrips every other major G7 nation, is largely due to the unique buoyancy of business investment in the US, reflecting actions to slash regulation, lower corporate income taxes and accelerate depreciation.

The benefits of faster productivity gains were evident in how the US could pay higher wages without hampering its competitiveness or devaluing its currency. Labour compensation in Canada and the US continued to rise at a similar rate over the past year (2.1 percent versus 2.5 percent). Wage increases in the US matched higher labour productivity, up 2.4 percent as output surged, which meant essentially no increase in unit labour costs. In Canada, productivity edged up 0.4 percent over the past year, so most of the increase in wages translated into higher unit labour costs. With unit labour costs rising faster in Canada than the US, the exchange rate depreciated 4.9 percent over the last four quarters partly in response to this loss of competitiveness (Statistics Canada 2019, Table 2). The lower dollar kept Canada's unit labour costs stable when measured in US dollars, but at the cost of higher prices for imported goods and services (including the cost of servicing debt denominated in US dollars).

Exports slump

The weakness in first-quarter GDP largely reflected a 1.0 percent drop in exports. Much of this decline originated in cutbacks to oil production mandated by the Alberta government's response to record low prices for its crude oil late in 2018. However, the weakness in exports extended far beyond the oil sector, with only three of other 10 sectors posting gains.

The slumping price for Alberta oil highlighted Canada's failure to build the pipeline capacity to match long-planned increase in oil sands production. Between 2014 and 2018, oil production in Western Canada rose by 800,000 barrels a day, most of it from the oil sands. However, despite being given years to build the transportation infrastructure to carry this added output, Canada expanded its pipeline capacity by only 500,000 barrels a day over the same period. The difference between rising oil output and pipeline capacity either had to be moved by rail at a high cost or was shut-in to Western Canada (especially for small producers who cannot access rail transport). At the same time, US oil production was surging due to the shale fracking revolution. In 2018 alone, US oil output rose by 1.5 million barrels a day, almost double the increase in Canada over the previous four years. The failure to expand markets beyond the US has been costly for Canada, which lost about $12 billion a year from either higher costs or lower prices for its oil.

The Bank of Canada found that the drop in non-energy exports reflected constraints firms face that limit their ability in increase exports, not the number of firms exporting (Brouillette et al 2018, 6). In other words, it was not due to destruction of capacity during the period of a high exchange rate, but originates in factors under Canada's control, such as labour shortages and capacity constraints (the very opposite of concerns about lost capacity). Other factors cited by firms include environmental and regulatory constraints, transportation bottlenecks and reduced supply of raw materials (notably of timber in BC following the pine beetle infestation). More worrisome is the decision of multinationals to shift investment and production outside of Canada, such as the migration of the auto industry to the Southern US and Mexico.

“Persistent weakness in non-energy exports reflects growing concerns in the business community about Canada's competitiveness even with a depreciating dollar.”

Persistent weakness in non-energy exports reflects growing concerns in the business community about Canada's competitiveness even with a depreciating dollar. As a result, Canada's share of US imports of non-energy goods declined from 16 percent to 10 percent between 2002 and 2017, with losses “widespread across export categories” (Brouillette et al 2018, 3). In early 2019, the Business Council of Canada responded to these challenges by launching a Task Force on Canada's Economic Future, focusing on six policy areas where action is needed to enhance Canada's economic prospects (Business Council of Canada, Undated).

Business investment remains weak

Business investment was mixed to start the year. Business fixed investment rebounded by 3.2 percent to recoup a 2.5 percent drop in the fourth quarter. However, most of the increase originated in the delivery of a number of aircraft (similarly, government investment was buoyed by the arrival of a number of ice-breaking ships). Therefore it is notable that imports of aircraft plunged from a record $1.2 billion in February to just $0.1 billion in April after a second plane crash led to the suspension of deliveries of Boeing's new Max 737.

Elsewhere, capital spending on oil and gas continued to decline for the fifth straight quarter, with a drop of 4.8 percent in current dollars (data for this sector is not available in constant dollars). It will be difficult to sustain higher business investment when corporate profits remain weak; profits rose by 1.7 percent in the first quarter, but after a 6.2 percent drop in the fourth corporate earnings remain little changed from their level of a year ago.

The persistent slowdown in business investment since 2008 has left investment 30 percent below what it would have been if sustained at the long-term average growth of 4 percent posted between 1992 and 2007. Initially, analysts thought weak investment was related to cyclical factors such as weak economic growth and uncertainty. However, as investment failed to respond even in industries where capacity utilization is high, economists have begun to consider that the shortfall reflects structural factors such as weak productivity growth, lower oil prices after 2014 and an aging population (Barnett and Mendes 2017). To this list one should add government policies; the pipeline industry, for example, is anxious to invest billions in new projects but has been continually frustrated by government regulators refusing or rescinding approval.

Despite weak investment, corporate debt continues to increase in quantity while its quality decreases. Non-financial corporate debt rose to 315 percent of income in 2018, well above its historical average. Furthermore, the Bank of Canada found debt is concentrated in firms "that have poor debt-service capacity and low liquid asset holdings" notably in commodity-related industries (Bank of Canada 2019). The risk to these firms is increased because recent bond issuance was concentrated in US dollars, exposing these firms to risk from a falling exchange rate.

> "So while jobs proliferated in the past 12 months, on average these jobs generated little extra income."

Meanwhile, firms continued to accumulate inventories, up $16.1 billion in the first quarter. This raised the ratio of stocks to sales to 0.846, a substantial increase from 0.82 in the third quarter that will reduce the need for firms to boost output in the short-term. The increase in inventories occurred despite a drop in oil inventories resulting from the government-mandated cuts in Alberta's oil production.

Consumer spending rebounds while housing slumps

Household demand was mixed; consumer spending rebounded while housing continued to retreat for a fifth consecutive quarter. Consumer spending rose by 0.8 percent in the first quarter, its first substantial increase in a year. The upturn in consumer spending was financed by higher debt and lower savings as real incomes remained weak. Real disposable income has risen by a tepid 1.6 percent over the past year, including a 0.7 percent gain in the first quarter.

The slow growth of income in the past year occurred despite a 1.8 percent gain in employment. The discrepancy between sluggish output and buoyant employment growth is reconciled by a gain of just 0.5 percent in hours worked in the business sector in the past year, revealing that employees were working a reduced workweek which capped their income growth. The reduction in hours worked was particularly pronounced in Ontario, where the average workweek in the first five months of 2019 was 35.5 hours, down a full hour from 36.5 a year earlier. Most of the decline originated in people working very long workweeks of 50 hours or more. This suggests that when firms in Ontario balked early in 2018 at hiring more workers after the hike to minimum wages and draconian new labour legislation, they resorted to getting more hours out of their existing workforce. After a new more business-friendly government was elected, firms in Ontario have gone on a hiring binge adding 2.6 percent more workers, allowing them to reduce the need for some employees to work long hours.

So while jobs proliferated in the past 12 months, on average these jobs generated little extra income. With weak income growth, an upturn in spending such as consumers undertook early in 2019 had to be financed by dipping into savings or going further into debt, neither of which is sustainable over extended periods.

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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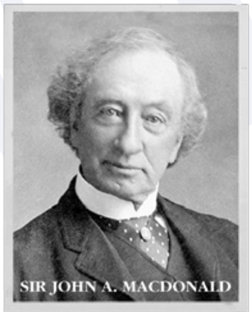
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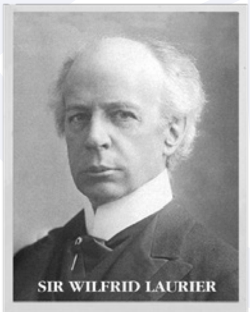
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