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True North in
Canadian public policy

Commentary

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Major Government Efforts to Stimulate the Economy Have Failed

Problems with Trans Mountain pipeline and NAFTA adding to uncertainty on Canada's economic outlook and federal infrastructure spending has fizzled.

Philip Cross

Overview

Economic uncertainty in Canada continues to plague business investment and consumer confidence. Several government initiatives to buttress economic growth have failed to produce their intended results. Neither did provincial government hikes to minimum wages produce the hoped-for stimulus to household incomes, instead resulting in slowing wage growth for people making above the minimum wage.

The federal government has also faced challenges on other economic fronts. Ottawa's attempt to ensure work started on the Trans Mountain pipeline was blocked by a court ruling. The much-trumpeted surge in federal infrastructure spending continues to falter, reflecting both delays in launching new projects and offsetting cuts in provincial capital spending. Meanwhile, the government has found itself in the early stages of a trade war with the US in the midst of its NAFTA renegotiations. As a result, firms are hesitant to commit to long-term investments in Canada without assured access to the US market.

Canada's economic growth picked up in the second quarter, although the increase appears unlikely to be sustained. Growth was primarily driven by higher commodity prices, with softer housing and labour market conditions and the continuing uncertainty over the future of NAFTA resulting in a decline in consumer confidence. The Macdonald-Laurier Institute leading economic indicator (LEI) points to slow growth at best in the second half of the year.

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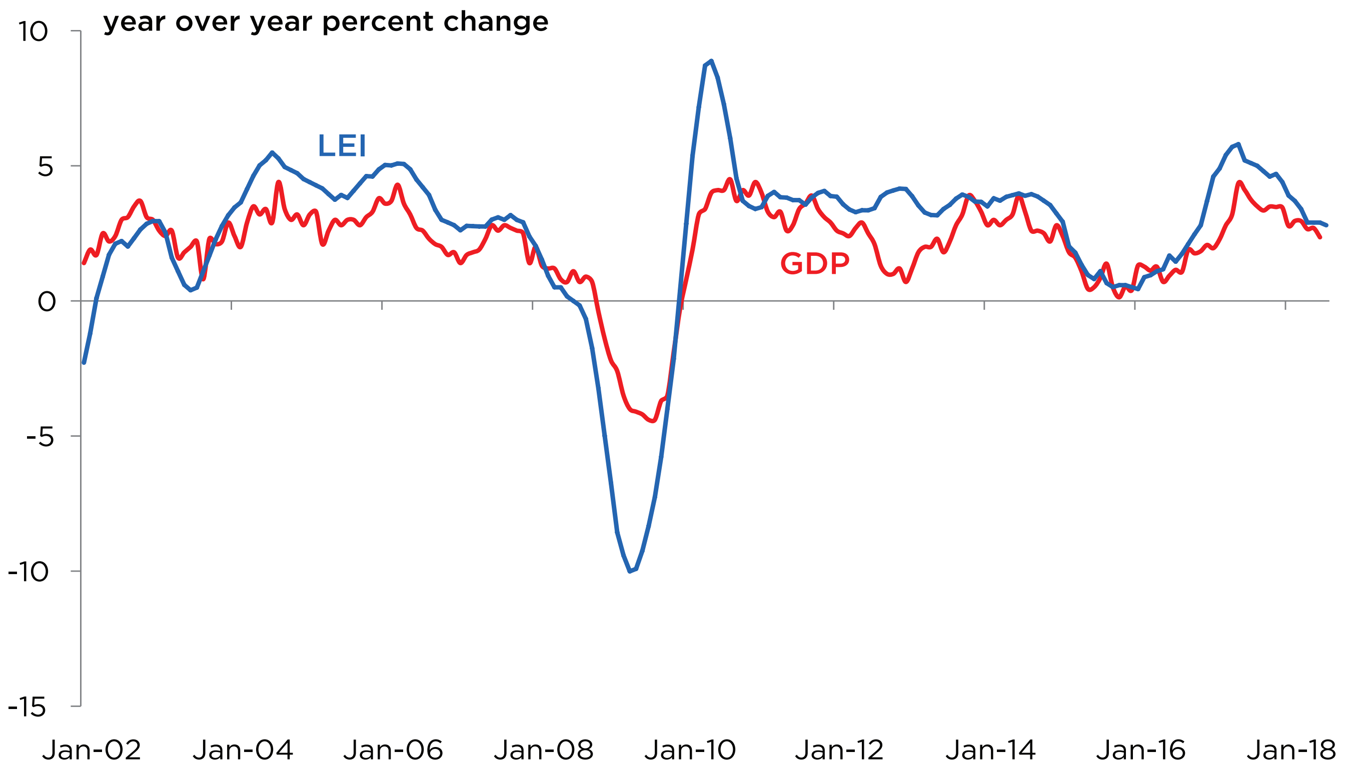
Introduction

Real GDP growth in Canada picked up to 0.7 percent in the second quarter after three consecutive modest gains of 0.4 percent. However, the upturn in growth in this year's second quarter is quite different from the acceleration in the first half of 2017. As can be seen in Chart 1, the gain in 2017 followed an improvement in the previous quarters, lifting year-over-year economic growth to 3 percent, its high-water mark since the recovery began in 2009. In 2018, the acceleration in growth following three quarters of slow growth left year-over-year growth at the 2 percent mark, which has become the norm during what has been an historically weak expansion.

Chart 1: MLI Leading Economic Indicator (LEI)



The second quarter improvement in growth is likely to be transitory, according to the Macdonald-Laurier Institute leading economic indicator. This index edged up only 0.1 percent in July, its third such marginal gain in the last four months. This signals a return to desultory GDP growth in the second half of 2018.

Growth in the LEI was sustained by higher commodity prices, which also supported rising stock market prices. Households remained a major drag on the overall index. The housing index continued to decline, although not as rapidly as early in the year after tighter mortgage rules took effect. New claims for unemployment insurance edged up for the first time since January. The combination of softer housing and labour market conditions and the uncertainty surrounding trade talks with the US and Mexico was reflected in a fifth straight decline in the Bloomberg-Nanos index of consumer confidence.

Business investment disappoints

The most disappointing feature of the GDP report was continuing weakness in business investment, which rose by only 0.4 percent – its slowest quarterly gain in over a year. The deceleration of business investment in Canada occurred despite a strengthening of energy prices, which should have favoured more spending by Canada's largest investment sector. The continuing lethargy of investment in Canada also stands in marked contrast with improving investment in the US.

Statistics Canada (2018) noted that the second quarter weakness of investment included a 6 percent drop in spending on oil and gas extraction from a year-earlier (seasonally adjusted data will become available later this year). This decline, despite the recovery of oil prices over the past year, reflected the completion of oil sands mega projects (the start-up of production in these plants was the leading factor in raising quarterly exports and GDP). These projects began before the collapse of oil prices in 2014. Firms decided to continue with their completion, which took several years given the extremely long lags in building oil sands plants. While investment in conventional oil projects fell almost immediately when prices crashed in 2014 and 2015, the full impact on the oil sands is only now becoming evident in 2018. The growing uncertainty surrounding the building of pipelines to transport bitumen to new markets will discourage new investments in the oil sands going forward.

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The reasons for the reluctance of firms to invest in Canada are easily identifiable. Continuing uncertainty surrounding the renegotiation of NAFTA makes firms hesitant to commit to long-term investments in Canada without assured access to the US market. There was the high-profile decision of Kinder Morgan in May to withdraw from a $7.4 billion expansion of the Trans Mountain pipeline connecting Alberta's oil sands to the West Coast. Kinder Morgan sold the project to the federal government after Ottawa could not show a clear path to how the pipeline would overcome its opponents (including the BC government).

Kinder Morgan's misgivings about the uncertainty surrounding the project were borne out late in late August, when a Federal Court of Appeal ruling reversed the federal government's regulatory approval of the project. This was the 17th attempt by opponents to have the courts block the Trans Mountain pipeline. The suspension of work on Trans Mountain follows the rejection by a federal court of the proposed Northern Gateway pipeline and the suspension of the Energy East project after the federal government introduced a new regulatory framework.

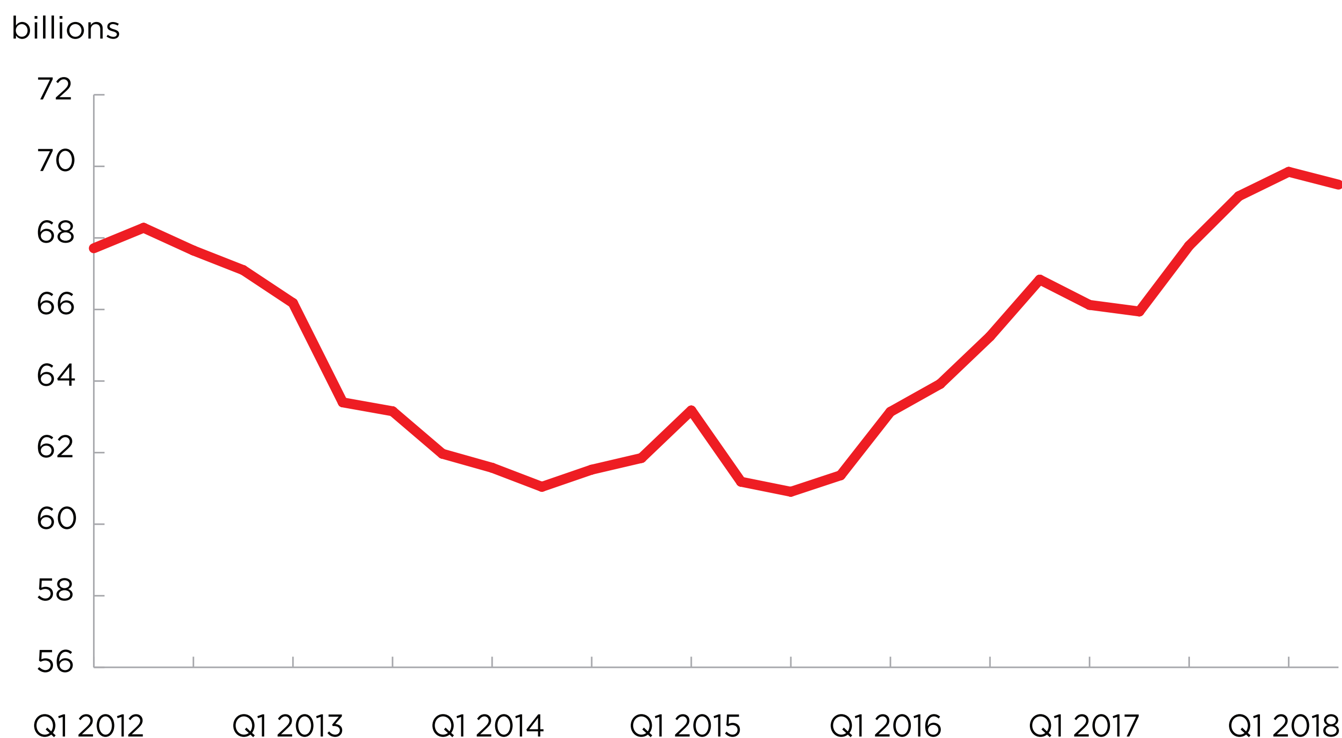
Meanwhile, the US government has significantly improved the investment climate south of our border. The tax reform passed late in 2017 lowered the corporate income tax and allowed firms to write off all investment spending after one year. The Trump administration continues to whittle away the regulatory burden on projects, with a stated goal of reducing the time line for issuing a permit for major infrastructure projects from up to 10 years to less than two. By comparison, the Trans Mountain pipeline has been in the planning stages for over five years. This will not only speed up investment spending but also lower costs, because delays mean "companies either have to pay workers to do nothing or tell them to go home and rehire them later" (Gingrich 2018, 254).

Inventories held by firms continued to accumulate, rising by $13.4 billion after a $16.0 billion increase in the first quarter. The economy-wide ratio of stocks-to-sales remained elevated at 0.76 in the second quarter, well above its low of 0.70 in 2011. This accumulation means firms can meet higher sales in the second half of the year by reducing inventories rather than increasing production.

Government infrastructure spending lags

Not only has the government failed to provide a business environment conducive to more investment by firms, it has not produced the promised boom in its own infrastructure spending. Capital spending by governments fell outright in the second quarter, its first decline in a year. Since the federal budget in 2016 announced with much fanfare its intention to significantly boost infrastructure spending, total investment by governments has risen a total of only 8.7 percent in volume, equivalent to about 0.2 percent of per year (Chart 2). This increase served mostly to recoup the reductions after 2012, when the federal government decided investment stimulus to the economy was less important than returning its fiscal position to a surplus.

Chart 2: Real Gross Fixed Capital Formation Government



Source: CANSIM Table 380-0064

There are several reasons for the slow increase in infrastructure investment by governments. To start, the federal government has been slow to roll-out new projects. In the 2016 federal budget, the government intended to spend $10.2 billion in fiscal 2017 and 2018. The 2018 budget shifted $3.6 billion of this spending to future years (Parliamentary Budget Officer [PBO] 2018, 2). Almost $2.5 billion of this delay was from fiscal 2018, with over

half in public transit projects which in most cases must be coordinated with other governments. Delaying capital spending may also reduce its economic impact; because the economy is operating closer to its capacity limit now than in 2016, the PBO (2018, 8) said it is more likely that increased infrastructure spending would induce the Bank of Canada to raise interest rates, reducing the stimulus of infrastructure investments.

The PBO also found evidence that higher spending on infrastructure by the federal government was partly offset by lower spending by the provinces. The provinces revised down their projected capital spending from $50.6 billion to $46.7 billion in fiscal 2017 and from $57.0 billion to $52.6 billion in fiscal 2018. The PBO (2018) concluded that these cuts to provincial infrastructure investment “could partially offset federal capital increases and likely diminish the magnitude of economic gains” (7).

Exports lead growth

Exports rose by 2.9 percent, their first significant advance in a year. A surge in oil exports led the way, as expanded oil sands capacity came on line after years of investment. As well, there was a significant increase in exports of steel and aluminum before US tariffs took effect in June. Steel exports rose by 40 percent between February and May, and then fell 36.8 percent when a 25 percent tariff took effect. Aluminum, which was subject to a smaller 10 percent tariff, saw exports surge 28.5 percent between February and May, and then retreated 7 percent when the tariff took effect.

Non-energy exports posted modest gains in the second quarter, after little change in recent quarters. Consumer goods and aircraft led the increase, as automotive exports continued to slow. Some of these gains reflect the surge in growth in the US economy to an annual rate of 4.2 percent in the second quarter.

Household demand mixed

Household spending in Canada was mixed, as an upturn in consumer spending on goods and services accompanied a continued slowdown in housing. With household income growth slowing to only 0.7 percent, barely ahead of inflation, households resorted to more borrowing and less saving to increase their outlays. Net borrowing by households rose to an annual rate of $80.9 billion in the second quarter, up from $74.8 billion in the first quarter and $71.6 billion late in 2017. Meanwhile, the personal savings rate fell from 3.9 percent to 3.4 percent.

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One reason household spending decelerated in the first half of 2018 is the tightening of mortgage regulations that took effect on January 1. However, there has also been a notable slowing of income growth despite several highly-publicized increases in minimum wages for all the major provinces. Compensation of employees was rising at a steady quarterly pace of 1.4 percent in the second half of 2017. After Ontario raised its minimum wage by about 20 percent on January 1, wage growth slowed to 1.1 percent in the first quarter. Several other provinces raised their minimum wage in the second quarter, notably a 10 percent hike in BC as well as smaller increases in Quebec and the Atlantic provinces. The hope behind these increases was not just to raise the minimum wage, but in so doing provoke increases for people earning just above the minimum. Instead, compensation growth decelerated again, to just 0.7 percent in the second quarter.

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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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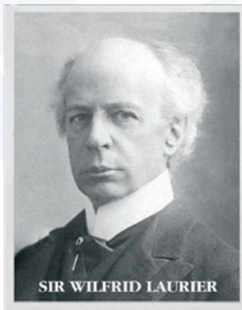
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