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True North in Canadian public policy

Commentary

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Economic outlook darkens even after free trade deal with US and Mexico

Deteriorating outlook for the Canadian economy further deters business investment.

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Overview

Economic growth subsided in the third quarter, as business investment slumped, exports stalled and household spending slowed. The Bank of Canada's plan to shift the sources of growth from household spending to business investment and exports is further threatened by the sharp downturn in Canada's oil industry late in the year when prices reached record lows. Both business investment and exports relied on the energy sector for much of their growth in the first half of the year.

Measures such as higher interest rates and tighter lending standards have curbed household demand, leaving the economy with few sectors to support growth. The deteriorating outlook for Canada's economy is reflected in a downturn in the Macdonald-Laurier Institute's leading economic indicator (LEI) for October, with only two of the ten components posting gains.

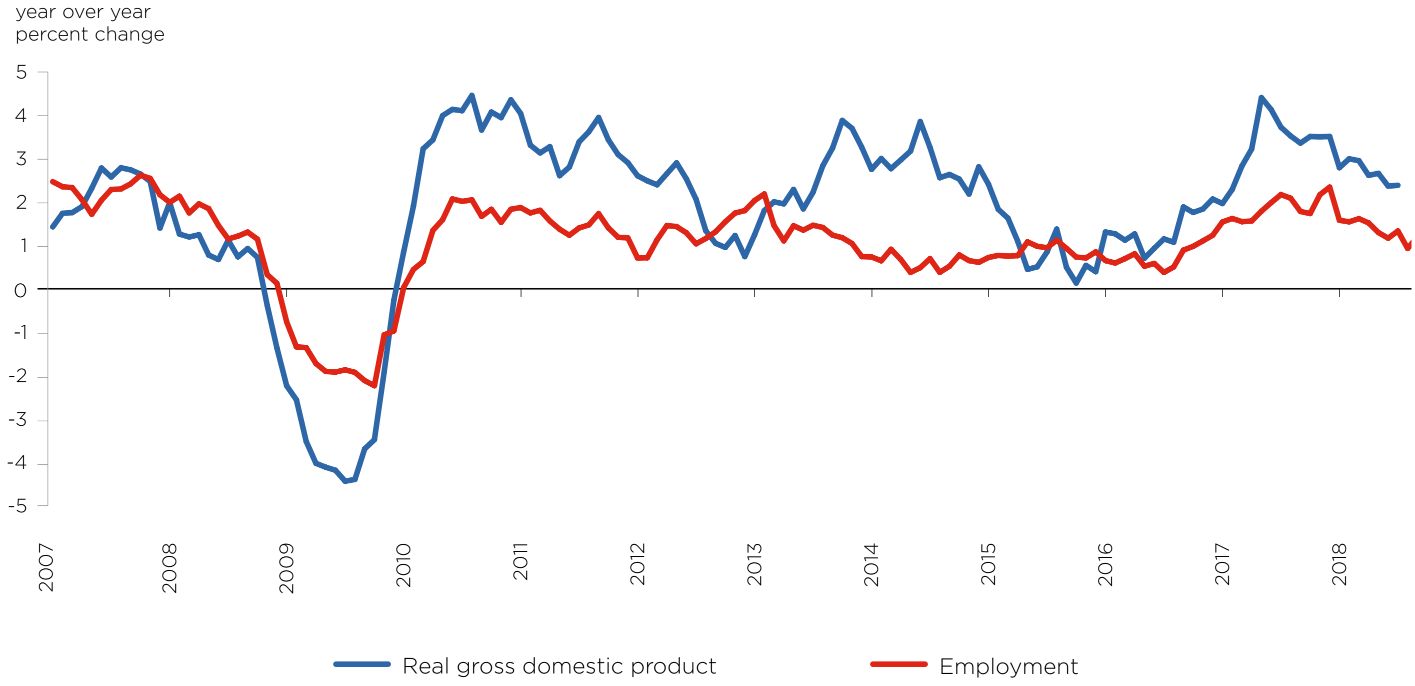
Introduction

Economic growth remained sluggish in the third quarter, with real GDP up 0.5 percent. Apart from an upturn in the second quarter, annualized growth has been 2.0 percent or less every quarter since early 2017.

Canada's underlying economic performance is even weaker after accounting for a significant surge in population growth. Over the past year, Canada's population has risen by 1.4 percent, its largest increase in 30 years and the most in the G7. Faster population growth should stimulate the economy by boosting demand for housing and consumer products as well as increasing the potential supply of labour. However, the recent surge in population has not provided a meaningful boost to Canada's economy. Instead, subtracting population growth from Canada's GDP growth leaves a meagre 0.7 percent gain in real incomes per capita.

Since Canada's recovery began in 2009, on three different occasions real GDP growth reached 4 percent on a year-over-year basis (2010, 2014 and 2017 in Chart 1). In each instance, hopes of a sustained upturn were dashed as growth soon subsided to between 1 and 2 percent. The slowdown of the Canadian economy to 2.1 percent growth over the past four quarters is especially noteworthy given the acceleration of growth in the US to 3.0 percent, led by a 7 percent increase in business investment.

Chart 1: Output and employment, 2007-2018

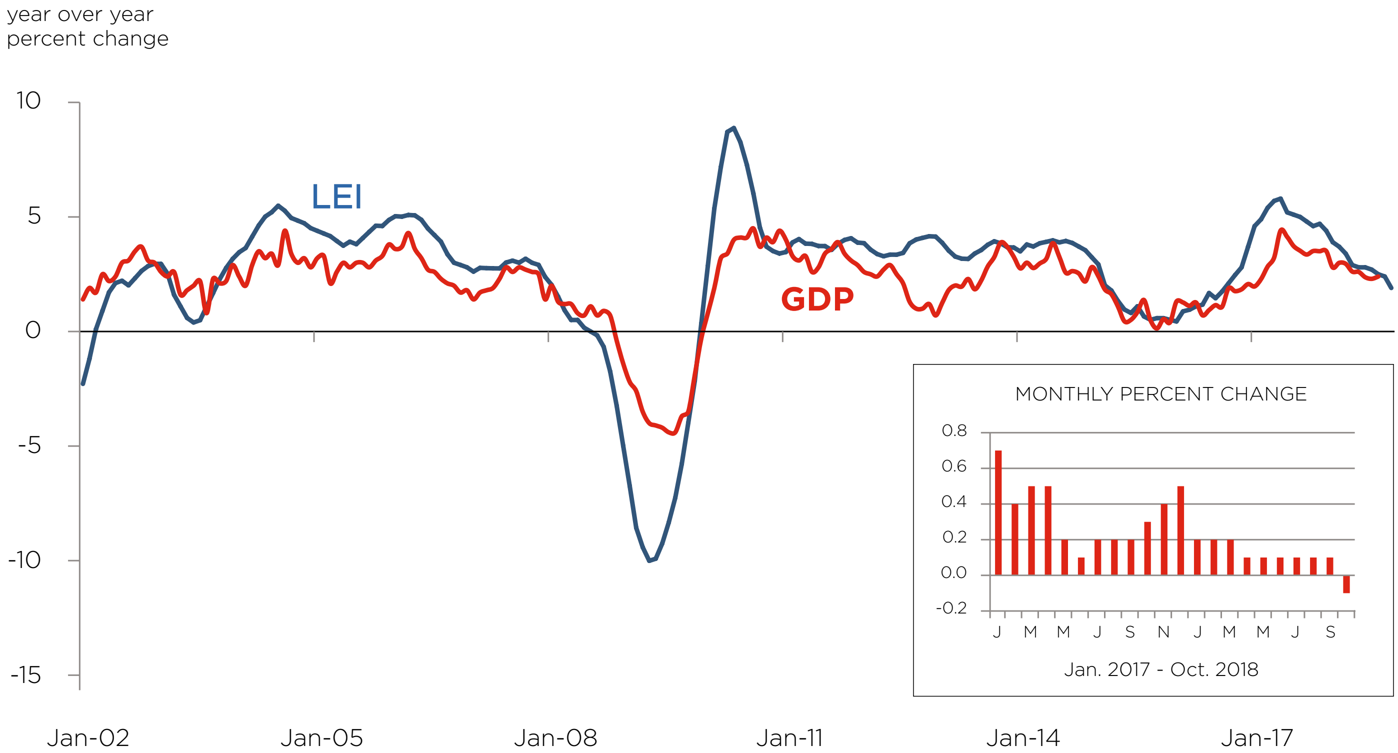


Source: Statistics Canada, tables 36-10-0434-01 and 14-10 -0287-01.

Outlook for growth darkens

Canada's growth is likely to weaken further late this year and into 2019. The Macdonald-Laurier Institute's LEI dipped 0.1 percent in October, its first decline since January 2016. Six of the ten components retreated, two were unchanged and only two advanced. The weakness was widespread, affecting sectors ranging from consumer sentiment and employment insurance claims to commodity prices and the stock market to new orders for durable goods. The housing index was an exception, posting its first significant gain of the year as both housing starts and existing home sales increased. Despite another solid gain in third-quarter real GDP of 0.9 percent, the outlook for the US economy dimmed as the US leading index rose only 0.1 percent, its smallest gain since the summer of 2017.

Chart 2: MLI Leading Economic Indicator (LEI)



The deteriorating outlook for the Canadian economy is evident in a number of high-profile developments in the autumn. Most significantly, prices for Western Canadian Select crude oil fell to a record low, prompting another wave of cutbacks in investment and output and calls for government to mandate cuts by all producers. Lower domestic oil prices were of little benefit to manufacturers in Eastern Canada, who continue to pay above $50 (US) a barrel for imported oil. General Motors announced that its century-old assembly plant in Oshawa will close permanently at the end of 2019, while Bombardier announced layoffs in its aerospace division. One bright spot for the Canadian economy was the official launch of work on two LNG projects in BC that will export natural gas to Asian markets where prices are higher than in North America.

The increased pessimism about the prospects for the economy were evident in the Institute of Corporate Directors quarterly survey. The survey of 600 directors revealed only 28 percent believe the Canadian economy will improve over the next two to five years, compared with 52 percent a year ago. Clearly the resolution of uncertainty surrounding free trade talks with Mexico and the United States has been replaced by an even deeper concern about the course of the global economy, including a slowdown in China and Europe, falling commodity prices and increased turbulence in global financial markets.

Slumping energy threatens a shift to investment and exports for growth

The slumping trend of the Canadian economy undermines the Bank of Canada's stated intention to normalize interest rates. Slowing growth puts the Bank of Canada in a difficult position. It wants to normalize interest rates to curb household debt levels and cool an over-heated housing market. However, if a weak economy prevents further interest rates hikes, it must rely on regulations alone to cool the housing market, especially in Toronto and Vancouver. The impact of tighter rules for mortgage lending that took effect on January 1, 2018 already appears to be waning, to judge by the increase in both housing starts and existing home sales in recent months.

While housing and consumer spending has slowed, the third-quarter data showed a retrenchment in business investment and a stall in exports. The reliance on the energy sector by both business investment and exports for growth highlights how sustained increases in these sectors are imperilled by the sudden downturn in Alberta's oil industry in the final months of 2018.

Business investment remains a critical source of weakness

Business investment fell by 1.8 percent in the third quarter after stalling in the second. The drop was led by lower investment in engineering projects, about half of which reflects spending by the oil and gas industry. Total business investment had edged up at the turn of the year, which was mistakenly interpreted by some analysts as symptomatic of a sustained upturn. Instead, it was related more to the completion of oil sands projects undertaken years ago. With these projects now completed and the price of Western Canadian oil cratering in recent weeks, the outlook for energy investment in Alberta is bleak.

> "Uncertainty surrounding free trade talks…has been replaced by an even deeper concern about the course of the global economy.

Elsewhere, spending on major resource investments is mixed. Work on the Trans Mountain Pipeline was stopped by court order, although Enbridge's expansion of its existing Line 3 pipeline connecting Alberta to Wisconsin will be completed by next summer (five years after it was initiated). Construction was halted at least temporarily on Newfoundland's Muskrat Falls hydro project, while the new Quebec government announced it would not proceed with investments in wind farms. The persistent weakness of business investment motivated the federal government to adopt a number of measures in November 2018 to stimulate capital spending, notably accelerated write-offs for investment.

Export volume had risen in the first half of the year, largely due to the coming on-line of new output from the oil sands as projects were completed. Energy exports accounted for $3.3 billion of the total increase of $4.6 billion in the volume of goods exports between the fourth quarter of 2017 and the third quarter of 2018. No other sector contributed more than $0.5 billion to growth.

Household spending slows as incomes continue to lag

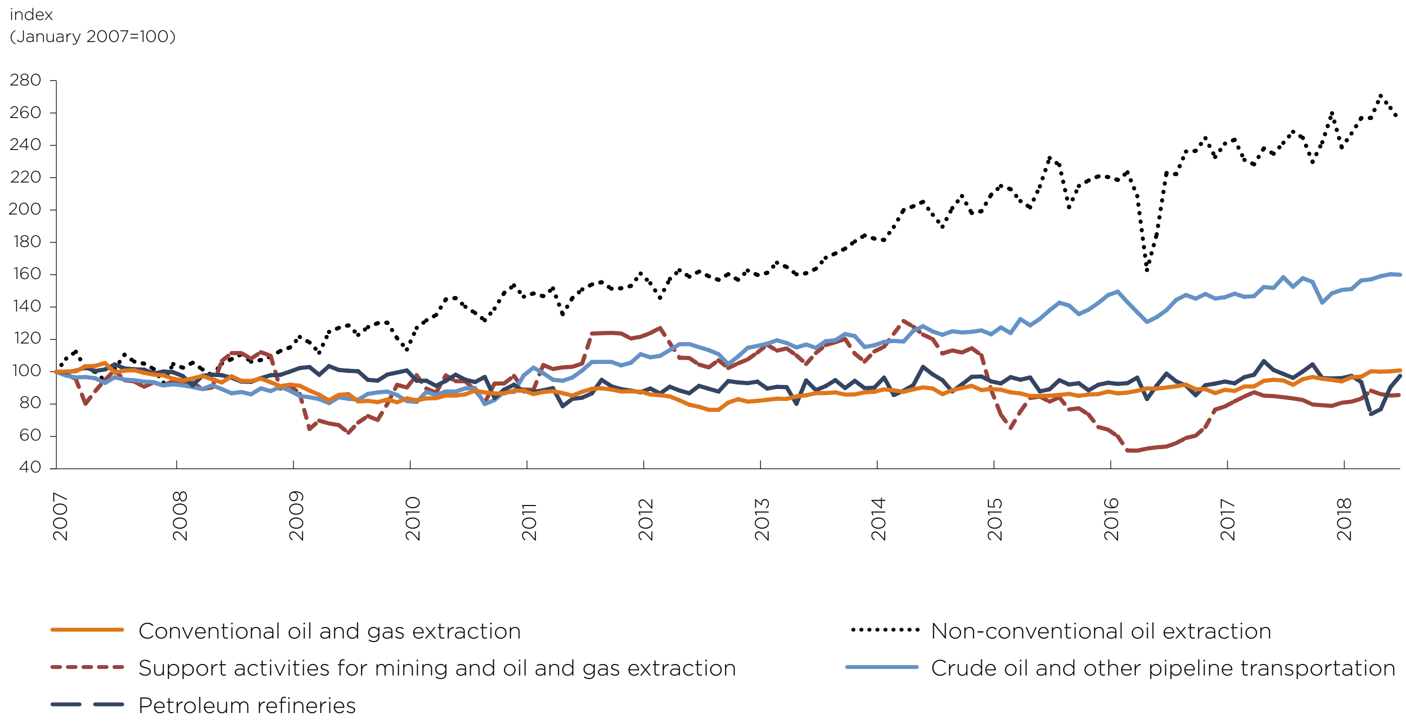
Consumer spending growth continued its year-long deceleration, as its 0.3 percent in the third quarter was the smallest increase since 2016. The deceleration of consumer spending is notable for at least two reasons. On the one hand, it allowed households to stabilize their ratio of debt to income. On the other hand, it reflects weak household income growth this year, despite misguided efforts by governments in Ontario and Alberta to boost incomes by sharply raising their minimum wages.

Wage growth remains stuck at about 2 percent, barely keeping pace with inflation. Wages have not picked up despite record low unemployment, a reflection that low unemployment is more a reflection of structural changes in the labour market such as aging as a reflection of the cyclical strength of the economy

Recent developments in the oil and gas sector

The oil sands have powered most of the growth of Canada's oil and gas industry for a decade. The dominance of the expansion of the oil sands in growing Canada's oil and gas industry in recent years is evident in Chart 3. Since 2007, oil sands output has risen by about 250 percent. Pipeline transport has increased by 40 percent, carrying this bitumen to destinations within North America.

Chart 3: Real gross domestic product, selected industries



Source: Statistics Canada, CANSIM table 36-10-0434-01

However, outside of this growth in oil sands output, there has been a net decline in the production of other types of oil and gas. Conventional oil and gas output was unchanged, while there have been declines in both drilling for oil and gas and petroleum refining. Exploration and development of oil and gas were particularly hard hit during the 2014 oil price crash, falling nearly 50 percent by early 2016, and another round of cuts began in the third quarter of 2018. These cuts will be amplified by the Alberta government's decision in early December to mandate an 8.7 percent drop in oil production. The announcement provoked an immediate upturn in the price of Canadian oil.

The heavy reliance of Canada's oil and gas industry on the oil sands for growth is noteworthy because the period of developing large scale oil sands projects has come to at least a temporary end. The rapid expansion of oil sands production in 2018 reflected the decision to launch several large projects in 2014 when oil prices were still high. Given the long lags in their construction, these projects only came on line in 2018. However, persistently weak prices for Western Canadian oil, largely the result of the inability to reach markets outside the US where prices are higher, has discouraged new projects from being undertaken.

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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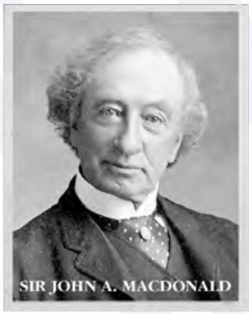

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BARBARA KAY, NATIONAL POST COLUMNIST

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