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Commentary

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Coronavirus hurts, but many of Canada's economic problems are homegrown

Economic growth continues to be weighed down by further declines in exports and business investment, further exposing the Canadian economy to risk.

Philip Cross

Overview

Canada's economic growth slowed to a crawl by the end of 2019, weighed down by further declines in exports and business investment. Partly as a result, business sector GDP and productivity in the US continued to grow at least twice as fast as in Canada, further weakening our competitive position. The outlook for 2020 is dampened by numerous supply shocks early in 2020, most notably the coronavirus, which took an increasing toll on the global economy and has mutated into lower demand. In addition, some of Canada's problems were home-grown, notably protests over pipeline construction that symbolize an underlying hostility to resource development.

More broadly, investment intentions for 2020 remain weak, as Canada struggles to reconcile attempts to lower carbonize emissions with the continuing large presence of its traditional oil and gas and transportation sectors and the need to preserve the competitiveness of its export base. There has been a shift in Canada's energy investments from its traditional base in oil and gas and pipelines to electricity and urban transit. Yet the attempt to shift commuter choices on masse from using autos to mass transit has been unsuccessful. With that in mind, the large investments being made in mass transit may end up becoming 'stranded assets.'

Introduction

Canada's real GDP growth slowed sharply to 0.1 percent in the fourth quarter. Excluding a build-up of inventories, final sales fell outright in the fourth quarter. The drop was led by lower exports and business investment, neither of which have responded to the Bank of Canada's attempts to shift some of the burden of supporting growth from household and government spending. Instead, both merchandise exports and business investment have fallen in four of the last six quarters, with net declines of 0.5 percent and 3.3 percent, respectively.

The underlying trend of growth was anemic even before the conoravirus spread early in 2020 and oil prices nosedived. Canada's paltry growth in the fourth quarter was symptomatic of widespread weakness in the major industrial nations outside of the US. Fourth-quarter real GDP fell outright in Japan, France and Italy and stagnated in Germany, with the EU as a whole matching Canada's 0.1 percent gain. The US economy continued to outperform all its peers with growth of 0.5 percent in the fourth quarter; over the past year, the US expanded by 2.3 percent versus 1.6 per-cent in Canada.

The gap between business sector GDP in the US and Canada was even greater. For all of 2019, business GDP rose by 2.7 percent on the heels of a 3.4 percent gain the year before; Canada's business output over the same two years was half as large at 1.4 percent and 1.8 percent. With labour productivity in the US also rising much faster (3.0 percent over the past two years versus 0.5 percent in Canada), firms could afford to pay American workers much higher hourly compensation, up 7.0 percent versus 5.7 percent in Canada.[1].

Supply shocks may mutate into a shock to demand

The underlying trend of demand was poised to rebound in the first half of 2020, according to the Macdonald-Laurier Institute's leading economic indicator (LEI) (chart 1). However, numerous supply disruptions likely will prevent production from recovering early in 2020. Several blockades protesting pipeline construction in British Columbia led CN Rail to suspend operations in February, while rotating teacher's strikes in Ontario also will depress output.

Most importantly, the conoravirus took an increasing toll on the global economy. Initially, financial markets assumed its impact would be largely confined to Asia. However, as the virus spread beyond Asia in February, stock markets and commodities such as oil posted their largest losses since 2009. The impact quickly began to be transmitted from financial markets to the real economy of production and employment. For example, the Institute for Supply Management (ISM) noted that US manufacturers in February already were experiencing disruptions to their supply chains, notably those based in China, preventing them from filling orders.

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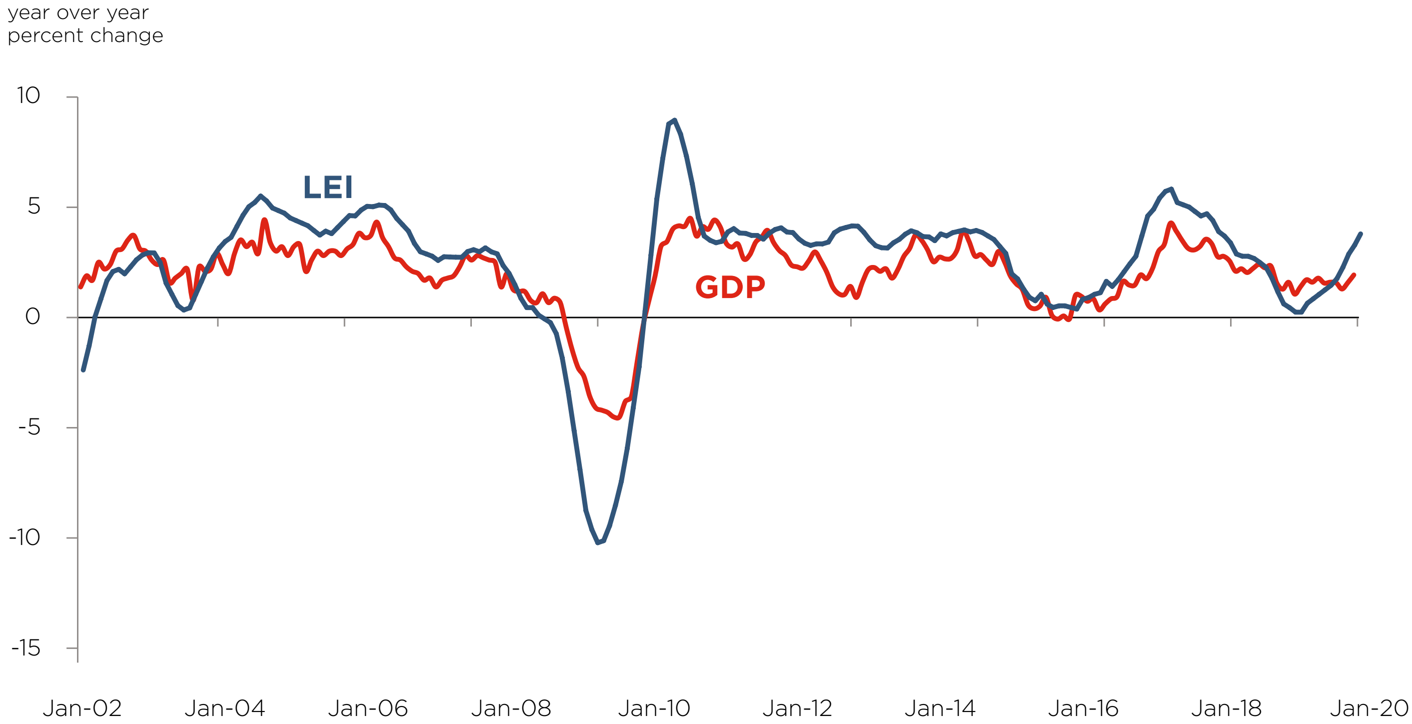
An industry can recover quickly from a short-lived supply shock; for example, a strike caused rail transport in Canada to drop 4.6 percent in November, but it rebounded 9.5 percent in December after the strike ended. However, the ISM warned that if the disruptions continued into April, firms would begin to cut jobs and incomes, converting the supply shock into a 'demand shock' whose impact would linger into the second half of the year.

Chart 1: MLI's Leading Economic Indicator (LEI), 2002-2019



Business investment plans stall for 2020

Firms remain reluctant to invest in Canada's economy. Statistics Canada's annual survey of investment intentions found that businesses plan a 2.9 percent increase in nominal investment spending for 2020, which would barely keep up inflation even without energy firms cutting investment further after oil prices swooned early in March. The same survey also found that firms did not invest as much in 2019 as they had projected at the start of the year, with nominal spending up 2.2 percent instead of plans for 3.8 percent growth. With prices rising 2.3 percent, the volume of business investment was little changed for all of 2019 and remained 19 percent below its peak in 2014.

The downward revision to business investment in 2019 dashed the false hopes raised in mid-year by the Bank of Canada that investment was beginning to recover (it even characterized business investment as "unexpectedly strong") (Bank of Canada 2019, 9). The slack in business investment should not have been surprising given that corporate profits have been little changed over the past four quarters, Canada lost its traditional advantage of lower corporate taxes than in the United States, while political and regulatory uncertainty continues to plague major resource projects. Weak investment plans into 2020, despite the recent ratification of the revised free trade agreement with the US and Mexico, suggests that uncertainty over trade negotiations was not a major fac-tor in weak investment in 2018 and 2019 (the Bank of Canada estimated that this uncertainty shaved 3 percent off investment in 2019) (Bank of Canada 2019, 15).

Transportation surpasses oil and gas investment

Since 2014 the major source of lower investment has been the energy sector, notably oil and gas. This does not only reflect low prices on world markets; for example, the US continues to ramp up investment in oil and gas. Instead, investment in Canada is being curtailed due to the steep discount for Canadian oil shipped to the US market and by regulatory uncertainty surrounding both the approval of major oil and gas projects in Canada and the ability to ship them by pipeline to overseas markets, where prices are higher than in the US.

For the first time since 2001, mining (including oil and gas) was not Canada's leading sector for investment, bypassed in intentions for 2020 by transportation and warehousing. Transportation projects are being driven by a mix of private investments in pipelines, air and rail transport and public investment in urban transit.[2]

Manufacturing investment was little changed for a second straight year, outside of outlays for cannabis production facilities totalling almost $1 billion. Eleven of the 21 manufacturing subsectors expect to spend more in 2020, down from 12 in 2019 and 17 in 2018. Most of the increase in manufacturing investment intentions was in Quebec.

Without necessarily proving causality, it is noteworthy that investment was stronger in provinces running budget surpluses (notably Quebec and BC) than those with large deficits (such as Ontario and Alberta). Quebec continues to be a beacon for business investment, with intentions for 2020 up 10.8 percent, the most among Canada's major provinces. Transportation, manufacturing and utilities drove the increase. British Columbia also posted a large increase, with major boosts from the Trans Mountain Pipeline and an LNG terminal. Ontario posted a small rebound from lower investment in 2019, although most of the increase was in urban transit as manufacturing planned a second consecutive decline. Alberta continued to be hamstrung by low levels of investment in oil and gas, a weakness symbolized by Teck's decision in late February not to proceed with its Frontier oil sands project because of regulatory uncertainty and low prices for bitumen).

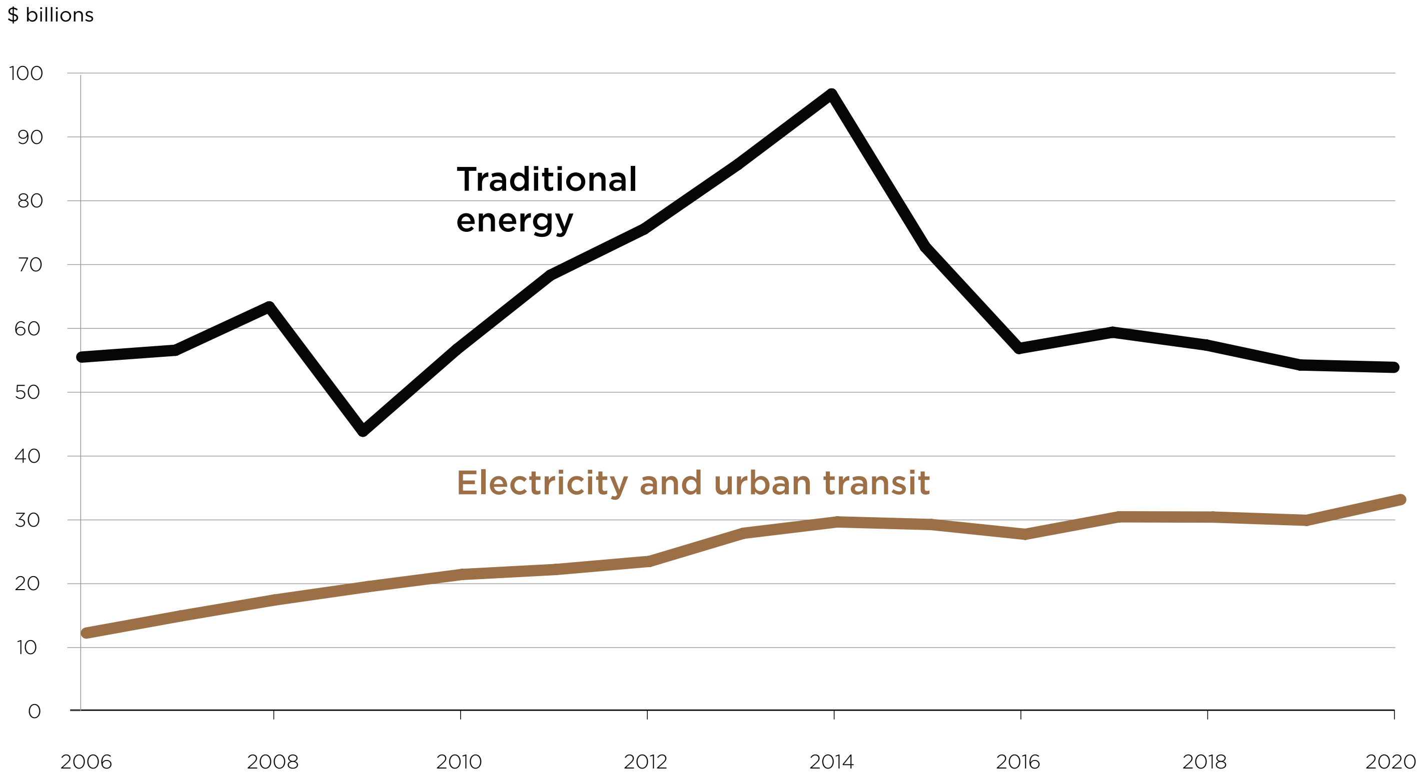
Investment shifts from fossil fuels to lower carbon emissions

Canada's investment profile shows an ongoing shift from traditional energy industries to investment in sectors intended to lower carbon emissions. Traditional energy industries are defined to include oil and gas,[3] petroleum refining, pipelines and natural gas utilities (data for coal mining is not publicly available but would not substantially change the results). Lower carbon industries include all electrical utilities (which in Canada is dominated by hydro and nuclear power as well as small amounts of solar and wind) and urban transit.

There has been a shift in Canada's energy investments from its traditional base in oil and gas and pipelines to electricity and urban transit. Since 2006, investment in traditional energy industries fell 3.4 percent, mostly due to steep declines in spending on oil and gas projects after 2014 (chart 2). Meanwhile, investment in lower carbon projects has nearly tripled since 2006 from $13.2 billion to $34.9 billion. Electrical utilities led the increase up to 2014, but since then their investments have declined by 9.5 percent. However, this slowdown has been more than offset by sharply higher investments in urban transit, notably mass transit projects in cities such as Ottawa, Toronto and Vancouver. These projects are designed to shift commuters from using automobiles to mass transit, thereby lowering carbon emissions.

Some Canadians will applaud the shift of investment from traditional fossil fuels to investing in power and transportation systems that lower carbon emissions. However, it is worth noting that the attempt to shift commuter choices on masse from using autos to mass transit has been unsuccessful. GDP for urban transit, which is based on the number of people taking trips on buses, light rail and subways, rose by 15.7 percent between August 2008 and December 2019, only slightly more than total population growth of 13.1 percent over this period and

Chart 2: Capital expenditures, Canada



Source: CANSIM 34-10-0035-01, 34-10-0036-01

slightly less than population growth in large cities where mass transit is concentrated.[4] The reluctance of commuters to stop driving automobiles is confirmed by Census data, which shows that nearly 80 percent of Canadians continue to take autos to get to work. A further piece of evidence is the steady increase in gasoline consumption, which rose 11.2 percent between 2008 and 2018.[5]

Will mass transit become 'stranded assets'?

Seen from this perspective, the large investments being made in mass transit are as likely to become the 'stranded assets' as the fossil fuel projects that critics claim will not pay off in the future if demand for fossil fuels collapses. Yet the outlook for oil and gas demand may not be as bleak as some claim; the International Energy Agency (IEA) does not see demand for fossil fuels peaking before 2040 (IEA 2019). Even then, demand for Canada's oil and gas may rebound if the shale boom in US oil and gas production is not sustained or if new pipelines open Asian markets for our oil and gas.

The large investments made in 'greening' Canada's electrical system have more of a captive market, since consumers do not have any choice but to consume the energy source that their hydro companies develop. Even then, several of the large developments in de-carbonizing electricity sources have proved very expensive. This includes major cost over-runs for the Muskrat Falls hydro project in Newfoundland, the Site C dam in BC and renovating nuclear plants in Ontario. While not yet stranded assets, governments considered abandoning all of these projects when their true cost became apparent. Nor is it even clear how much hydro projects lower carbon emissions on balance, since they come at the price of flooding large swathes of carbon-absorbing trees, which are a part of government plans to reduce emissions.

It is not evident that Canada is de-carbonizing its economy, despite the large investments in its electricity and urban transit systems. Investments in traditional energy and transportation systems remain at historically high levels. While investment in the oil and gas sector has fallen sharply since 2014, at $35 billion it remains close to its average of $44 billion in 2006-2008 when oil and gas prices were at record highs. The oil and gas industry projects a small increase in investment outlays in 2020, including a $1.1 billion increase in the oil sands.

Even within transportation, the $11.8 billion of investments in urban transit are dwarfed by the $29.8 billion planned by traditional industries such as airlines, railways, truck, pipeline and support for transportation (the latter category includes airports, harbours, and truck and pipeline terminals). Since 2014, investments in traditional transportation infrastructure has rise 51.4 percent from $19.7 billion, led by air transport and support activities. This reflects how, even as governments invest in green energy initiatives like electricity and urban transit, Canadians in their everyday life remain heavily-dependent on fossil fuels for most of their energy and transportation needs. De-carbonizing the economy will be prolonged, complex, and expensive, whenever it begins in earnest.

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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Statistics Canada. 2020b. "The Daily," March 4.

Endnotes

1 All the data in this paragraph comes from Statistics Canada 2020b.

2 Large public investments in urban transit are blurring the distinction between business and government investment, because they are often made by corporations controlled by government but which are counted as business investment. While business investment for 2020, calculated as total non-residential outlays excluding education, health and public administration, is projected to rise 2.9 percent, private investment will increase only 0.9 percent. See Statistics Canada 2020a.

3 Oil and gas include exploration and development.

4 Statistics Canada Table 17-10-0005-01. Population estimates on July 1. Statistics Canada Table 36-10-0434-01 GDP at basic prices by industry.

5 Statistics Canada Table 23-10-0066-01. Sales of fuel used for road motor vehicles.

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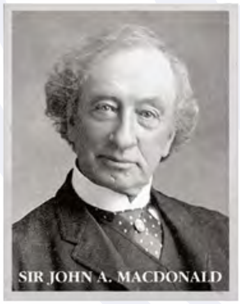

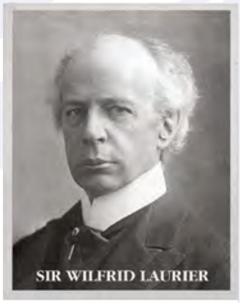

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