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Commentary

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Shocks Reveal a Vulnerable Canadian Economy

Recent GDP drop shows weakness, and a decline in housing will remove a key source of growth

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HIGHLIGHTS

Canada's economy is particularly vulnerable to single events, as we saw with the recently reported 0.4 percent drop in GDP in the second quarter of 2016.

It is statistically accurate to say that all of the decline was due to wildfires in Alberta affecting oil production. But this glosses over that the underlying trend of the economy is weak enough that singular events can significantly reduce GDP.

Potential growth of the North American economy has been curtailed by falling business investment in both Canada and the US over the past year. Attempts to stimulate the economy with government spending have not arrested this decline, and may even aggravate it if investors regard large budget deficits as future tax increases, and low interest rates as a reason to not save and invest.

Government deficits in Canada are clearly trending up again, led by the federal government. Over the past four quarters the federal deficit has expanded steadily to $13.3 billion, as spending growth nearly doubled while revenues stalled.

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The Macdonald-Laurier Institute's composite leading indicator gives a much more reassuring perspective on the short-term course of the economy than the quarterly drop in GDP. Even as output was falling, the leading index was signalling an upturn in growth with a third straight gain in July (Macdonald-Laurier Institute 2016). However, the year-over-year growth of the index is still the weakest since the depths of the 2009 recession.

The details of the leading index highlight some of the underlying problems in Canada's economy, notably in manufacturing and housing. The housing component contracted 0.8 percent in July, cooling a potentially overheated market but removing an important source of growth.

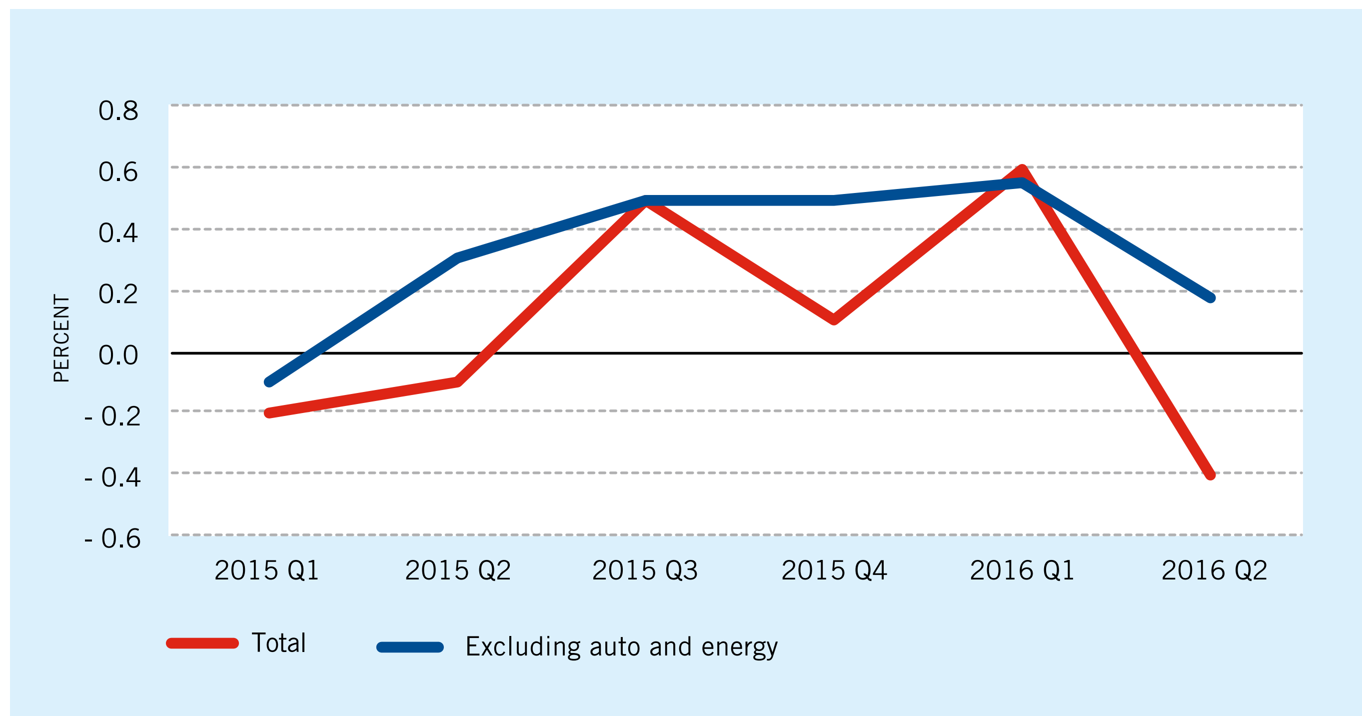
The slump in sales steepened in August, according to preliminary data, after a new tax on foreign buying of homes in Vancouver sent sales tumbling. The housing sector was a major reason why growth in the BC economy has been so dominant within Canada. Over the past year, employment in BC has risen 3.7 percent, compared with 0.2 percent in the rest of Canada. BC drove the increase in all the major economic sectors over the past year.

While we are continuing to experience volatility, steady growth in employment and the MLI leading indicator point to a resumption of growth in the second half of the year. However, this recovery will be constrained by falling business investment in Canada and the US, which not only reduces growth in the short-run but dampens long-run potential.

OVERVIEW

Real GDP in Canada continued to be very volatile in the second quarter, with a 0.4 percent drop following a 0.6 percent hike in the first quarter (see chart 1).

Chart 1: Quarterly GDP growth



Source: Statistics Canada, *Table 379-0031 – Gross domestic product (GDP) at basic prices, by North American Industry Classification System (NAICS), monthly (dollars),* CANSIM.

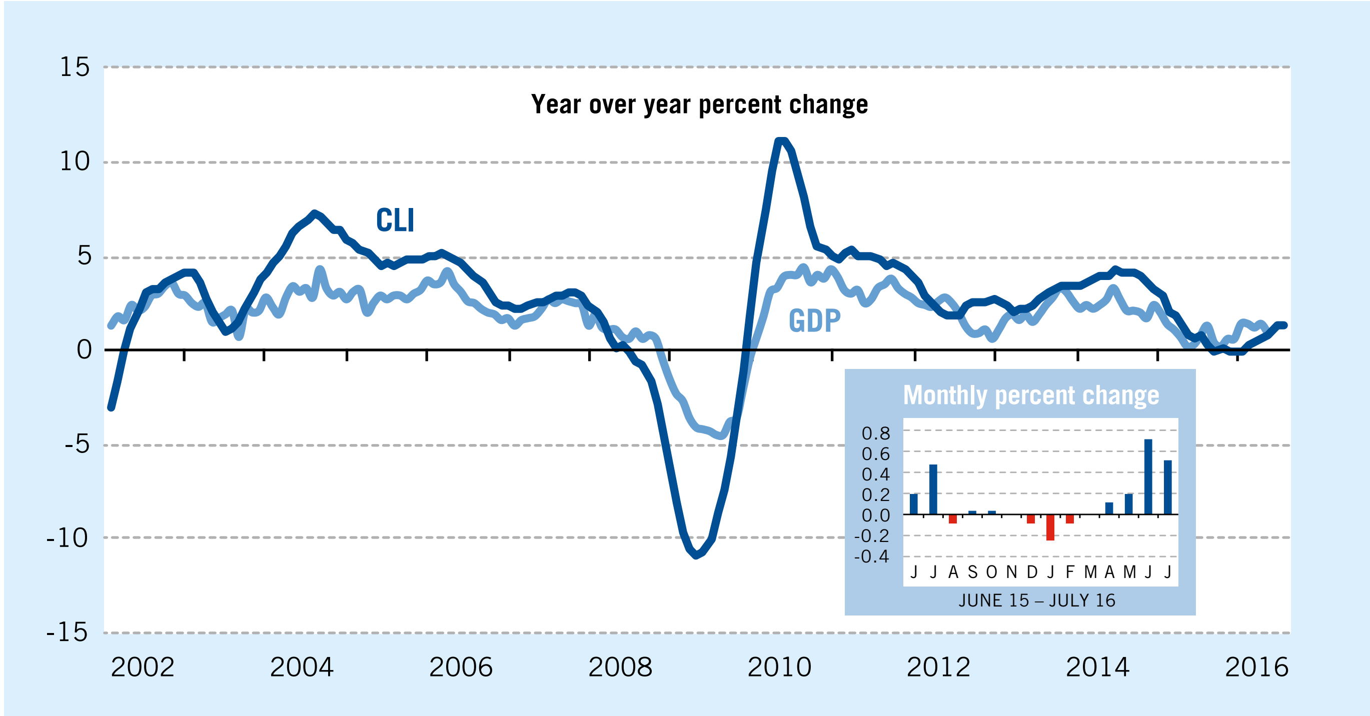
Most of the decline originated in the wildfires that disrupted oil sands production in the Fort McMurray area of northern Alberta. Excluding the 18 percent tumble in oil sands output, real GDP edged up 0.1 percent in the quarter. Employment continues to provide a better signal of the underlying trend of the economy, with a slow but steady gain of 0.2 percent, its fourth such increase in the past five quarters.

While it is statistically accurate to say that all of the drop in GDP was due to the wildfires, this glosses over the fact that the underlying trend of the economy is weak enough that singular events, even on the scale of these fires, are enough to significantly reduce GDP. This vulnerability was also evident in the first half of 2015, when the retooling of an auto plant and supply disruptions in the oil sands lowered GDP in consecutive quarters.[1] The real macroeconomic message from the data on the Canadian economy – and for that matter its neighbour to the south – is that years of unprecedented monetary and fiscal stimulus have yielded increasingly fewer returns in growth. Potential growth of the North American economy has been curtailed by falling business investment in both Canada and the US over the past year. Stimulative policies have not arrested this decline, and may even aggravate it if investors regard large budget deficits as future tax increases and low interest rates as a reason to not save and invest (instead devoting corporate spending to strategies such as share buybacks that are popular in the US).

THE MLI LEADING INDEX

The Macdonald-Laurier Institute's composite leading indicator gives a much more reassuring perspective on the short-term course of the economy than the quarterly drop in GDP. Even as output was falling, the leading index was signalling an upturn in growth with a third straight gain in July (see chart 2).

Chart 2: MLI leading economic indicator, 2002–2016



The 0.6 percent increase in the index reflects that the quarterly decline in output was driven by transitory factors, notably the wildfires. However, the 1.4 percent year-over-year growth of the leading index, while

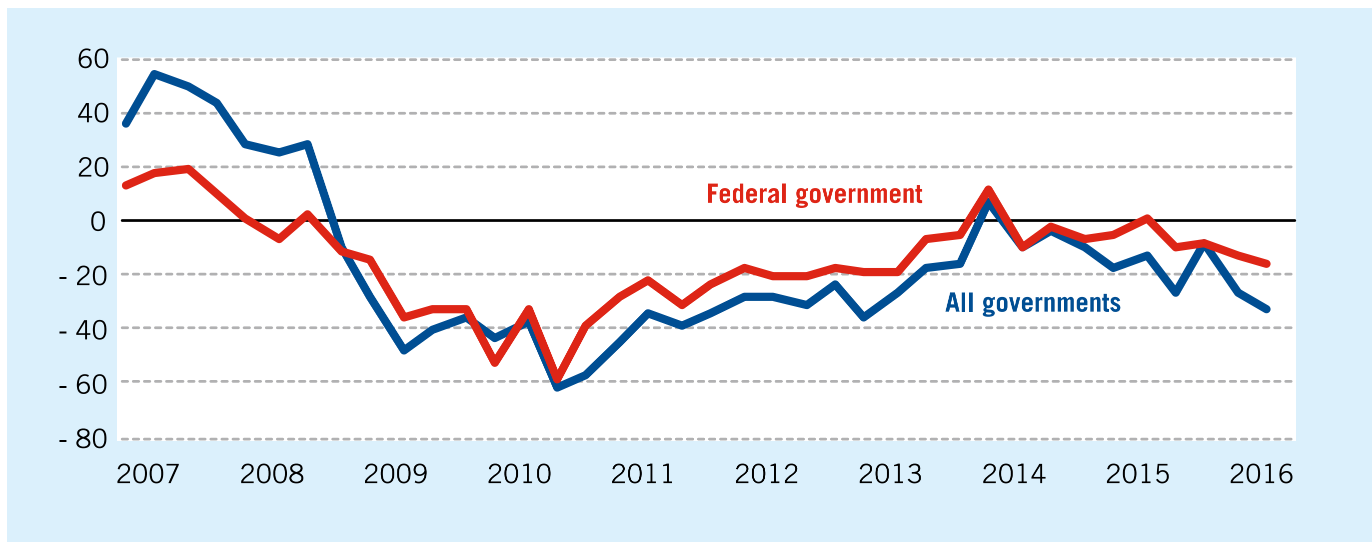
slightly better than the stagnation over the winter months, is still the weakest since the depths of the 2009 recession.

The details of the leading index highlight some of the underlying problems in Canada's economy, notably in manufacturing and housing, which will likely slow the rate of recovery in the second half of the year once the resumption of oil sands production is completed. In particular, manufacturing in Canada continues to be slow to respond to the stimulus of lower energy costs and the devaluation of the dollar from years of parity with the US greenback. The manufacturing components of the leading index were mixed. New orders continued to increase steadily, but the average workweek fell for the second time in three months. Part of the slack in manufacturing reflects continued sluggish growth in the US market, with US GDP up only 1.2 percent in the past year. As well, the housing component of the leading index contracted. While a cooling of the parts of Canada's housing market that were overheating is welcome, it does remove an important source of growth.

GOVERNMENT DEFICITS GROWING

Government deficits in Canada are clearly trending up again, led by the federal government according to data from Statistics Canada's (2016) National Accounts (see chart 3).[2]

Chart 3: Federal and all governments' budget balance, 2007–2016



Source: Statistics Canada 2016, Table 380-0080.

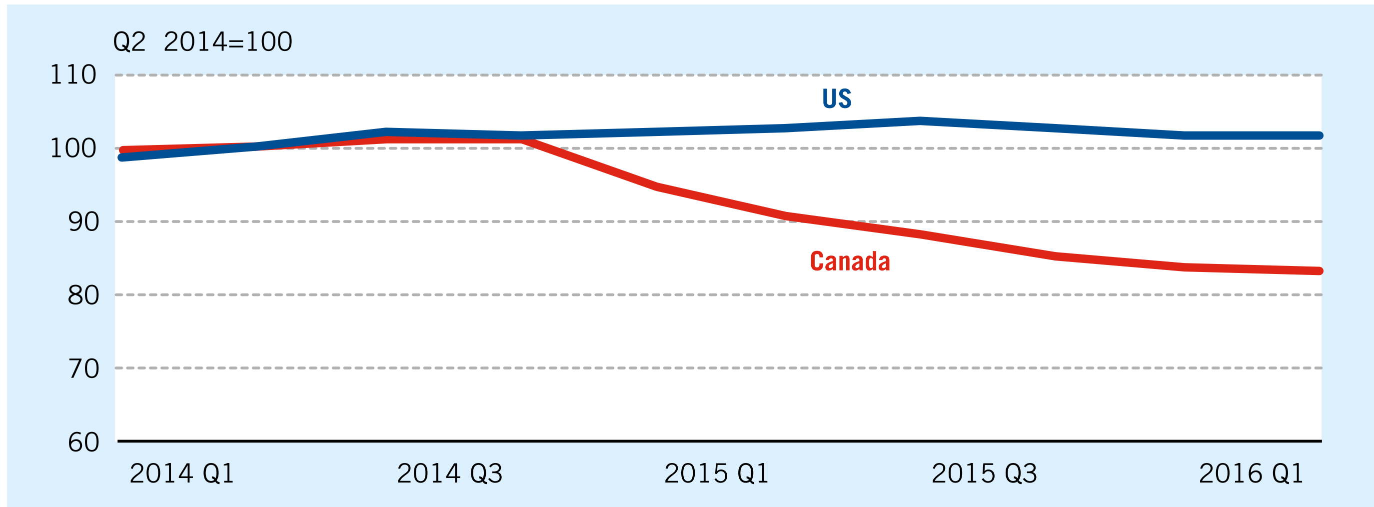
This is a marked reversal from the trend in 2014, when surpluses at the federal level helped to bring the overall government sector back into balance. Since then, the total deficit of all governments combined began to slowly rise to $22 billion in early 2015 as oil prices slumped. The deficit then increased rapidly to an annual rate of $38.0 billion by the first quarter and $43.7 billion in the second quarter.

Initially, the swing back to deficits in 2015 was driven by the provinces, as the federal government managed to post surpluses in the first half of that year, aided by its sell-off of shares in General Motors. However, over the past four quarters the federal deficit has expanded steadily to $13.3 billion, as spending growth nearly doubled to 4.3 percent while revenues stalled. A small part of the spending growth can be attributed to aid for relief efforts in Northern Alberta. A bigger increase will occur in the third quarter when larger cheques were mailed out under the expanded Child Care Benefit program.

INVESTMENT AND EXPORTS SLOW IN CANADA AND THE US

The source of the lack of vigour in the economies of both Canada and the US is readily identifiable. Business investment and exports have fallen over the past year in both countries (see chart 4).

Chart 4: Business investment in the US and Canada, 2014–2016

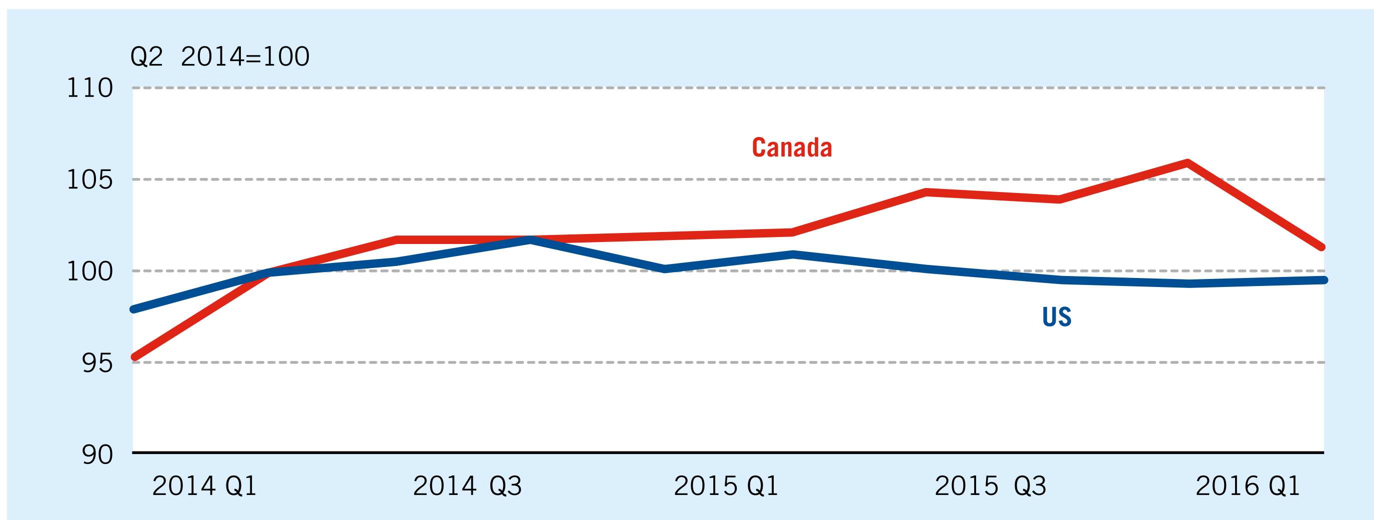


Sources: Statistics Canada, *Table 380-0064 –Gross domestic product, expenditure-based, quarterly (dollars unless otherwise noted)*, CANSIM and Bureau of Economic Analysis.

In Canada, this is not surprising in light of the sharp retrenchment of the oil industry. However, even non-energy exports and investment have been weak. The slump in investment and exports in the US also reflects weakness in both the energy and non-energy sectors of demand.

The second-quarter retrenchment in Canada's exports (see chart 5) partly reflected supply disruptions in the oil sands, as energy exports fell 5.5 percent in the quarter.

Chart 5: Total exports for the US and Canada, 2014–2016



Sources: Statistics Canada *Table 380-0064 –Gross domestic product, expenditure-based, quarterly (dollars unless otherwise noted)*, CANSIM, and Bureau of Economic Analysis.

However, the slowdown also reflected lower exports of manufactured goods, notably autos. Canada's auto industry had led the rebound of GDP growth in the second half of 2015, when Chrysler's minivan plant reopened after extensive retooling in the first half of the year. Auto output and exports dipped in the second quarter of 2016, as US auto demand softened after several quarters of sales over 17 million units (at annual rates). Reinforcing slower US sales is the steady erosion of Canada's share of North American production (Lee and Ierfino-Blachford 2016). Retooling only allows Canada to maintain but not expand its auto output, reducing its share of North American operations as production increases in the US and Mexico.

Some of Canada's exports benefited from transitory circumstances. Our lumber manufacturing is booming, as US restrictions on our softwood lumber exports expired last year for a 12-month period during which a new agreement is supposed to be negotiated. With these talks floundering, the US is likely to impose new restrictions in the near-term, adding to the friction over trade after the Obama administration decision to block the Keystone pipeline. Autos may get a lift from inventory-building in view of a possible strike this fall by auto workers in Canada.

HOUSING IS SLOWING

The housing component of the MLI leading index fell 0.8 percent in July. The drop originated in both lower housing starts and fewer sales of existing homes, the first time both fell in unison since the severe cold snap in February 2015. The downturn in housing is notable, because as recently as the summer of 2015 it dominated growth in the overall index with monthly gains of between 2 and 3 percent. The slump in sales steepened in August, according to preliminary data, after a new tax on foreign buying of homes in Vancouver sent sales tumbling. Housing demand and prices in Vancouver soared over the past year, raising concerns about a possible bubble in its housing market.

BC HAS DRIVEN THE GROWTH OF THE NATIONAL ECONOMY

The housing sector was a major reason why growth in the BC economy has been so dominant within Canada. Over the past year, employment in BC has risen 3.7 percent, compared with 0.2 percent in the rest of Canada. BC drove the increase in all the major economic sectors over the past year. Its housing starts rose 33 percent, accounting for all of the increase in Canada (by comparison, housing starts in Toronto fell from 42,000 to 38,000 over the past four quarters). Retail sales in BC rose 6.2 percent between the second quarter of 2015 and 2016, double the increase in the rest of the country. Manufacturing shipments from BC rose 1.8 percent over the past year, led by the 11.1 percent surge in wood sales as both domestic and export demand increased. Meanwhile, manufacturing shipments fell in the rest of the country.

Almost all the major sectors of manufacturing in Ontario continue to weaken. After peaking at $74.2 billion in the third quarter of 2015, shipments fell over the next three quarters to $73.8 billion. The slump over this period reflects a levelling off in the auto industry and declines in all capital goods industries (machinery, metal fabricating, non-metallic minerals, and computers and electronics) as well as chemicals. Even the food industry posted an unusual decline, as food is immune to cyclical fluctuations in demand (food was the only manufacturing industry that did not contract during the 2009 recession). Quebec's manufacturing sector fared little better, outside of gains in wood. Shipments fell from a high of $36.4 billion last year to $34.8 billion in the second quarter, with the largest declines in aerospace and primary metals (such as aluminum and gold).

CONCLUSION

For nearly two years, quarterly movements in Canada's GDP have been volatile. This reflects recurring disruptions to supply, notably for auto and oil output, on top of the ongoing adjustment Canada is making to adapt to lower oil prices. More volatility is assured this summer as Alberta's oil industry recovers from wildfires that ravaged production in the spring and as contract negotiations proceed in the auto industry.

Amidst all this volatility, it is difficult to focus on the underlying trend of the economy. Steady growth in employment and the MLI leading indicator point to a resumption of growth in the second half of the year. However, this recovery will be constrained by falling business investment in Canada and the US, which not only reduces growth in the short-run but dampens long-run potential. This leaves the economy vulnerable to repeated shocks to both supply and demand.

REFERENCES

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Statistics Canada. 2016. *Table 380-0080 – Revenue, expenditure and budgetary balance – General governments, quarterly (dollars).* CANSIM. Available at http://www5.statcan.gc.ca/cansim/a26?lang=eng&id=3800080.

ENDNOTES

1 Another factor that makes Canada vulnerable to micro events is the small size of its economy. In the US, where GDP is $18.4 trillion, the closing of one auto plant or energy output in one geographic area could not by itself reduce GDP outright.

2 All government data are in nominal dollars and expressed at annual rates.

ABOUT THE AUTHOR

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Philip Cross is a Munk Senior Fellow at the Macdonald-Laurier Institute. He is also a member of the Business Cycle Dating Committee at the CD Howe Institute. Before that, he spent 36 years at Statistics Canada, the last few as its Chief Economic Analyst. He wrote Statistics Canada's monthly assessment of the economy for years, as well as many feature articles for the *Canadian Economic Observer*.

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