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Commentary

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Fears About NAFTA Have Firms Hiring But Not Investing in Canada

Growth slowed by falling exports but expected to rise on flurry of home sales before new year

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OVERVIEW

Third-quarter growth of the Canadian economy decelerated as housing demand and exports contracted while business investment remained weak. Uncertainty surrounding the fate of renegotiations of the North American Free-Trade Agreement (NAFTA) with the US was reflected in a reluctance to invest in Canada. Instead firms in Canada met increasing demand by temporarily boosting employment instead of making the long-term commitment implied by investing. Canadians continued to finance much of their spending by borrowing more, especially households and governments.

INTRODUCTION

Growth in the Canadian economy slowed substantially in the third quarter, with real GDP increasing 0.4 percent after a 1.0 percent gain in the second quarter. Most of the slowdown originated in a steep drop in exports. As well, business investment remained sluggish while housing contracted for a second straight quarter. Growth was sustained by consumer and government spending and a build-up of inventories.

Growth is likely to pick up towards the end of the year, and indeed employment rose sharply in November. The Macdonald-Laurier Institute composite leading indicator for the Canadian economy rose by 0.4 percent in October, after five months of growth averaging 0.2 percent (see Chart 1). The upturn in the index largely originated in the housing index, which jumped 1.1 percent after five consecutive declines. Housing demand is likely to pick up significantly before January 1, when more stringent regulations on mortgage lending take effect that will raise barriers to home-buying. Higher oil prices also gave a boost to commodity prices and the Toronto stock market. The manufacturing sector remained the major drag on growth, especially in Ontario.

Normally, marked increases in employment as occurred in October and November would point to strong gains in output. However, the increases in 2017 are unlikely to follow this pattern. Hours worked did not

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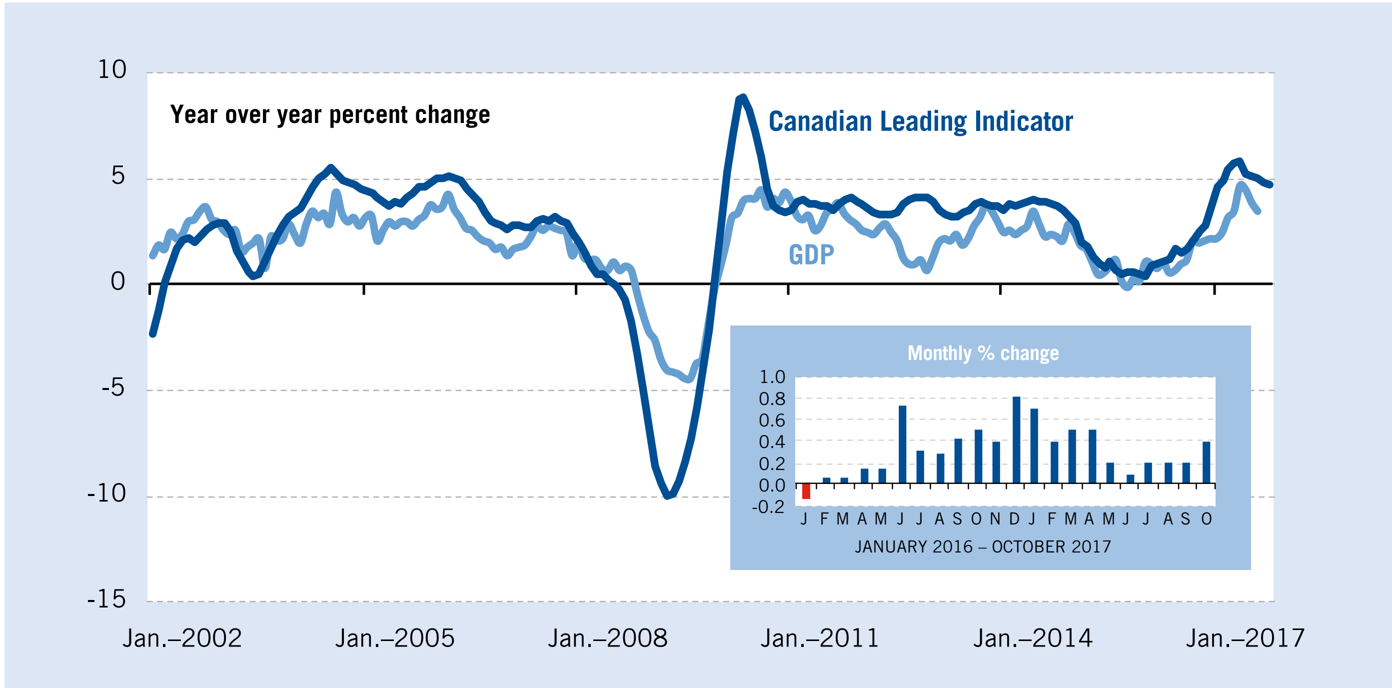
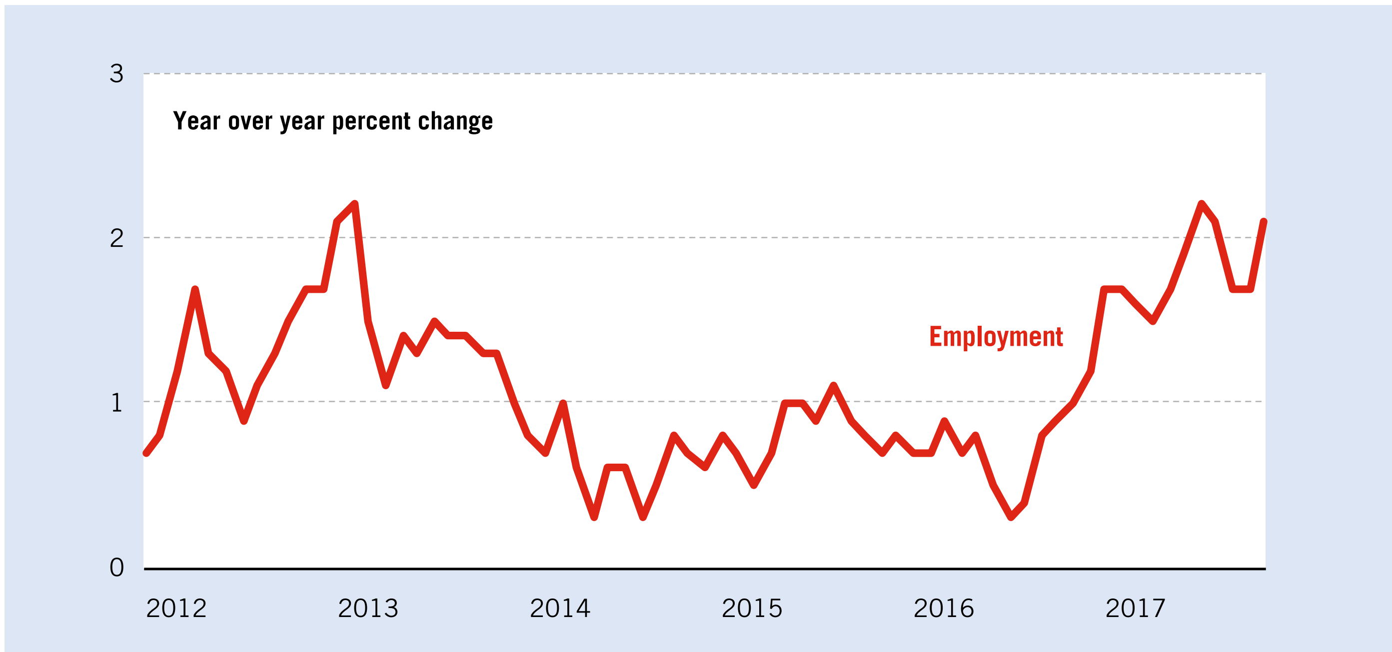
increase significantly, reflecting a preponderance of growth in part-time and not full-time jobs. As well, the survey week included the November 11 Remembrance Day holiday, which distorted the results.

Chart 1 MLI Leading Economic Indicator



More broadly, one of the most striking features of growth in the past year is the pick-up of employment growth (see chart 2), which is not entirely surprising given the stagnation of investment.

Chart 2 Employment



Source: Statcan Cansim Table 282-0087.

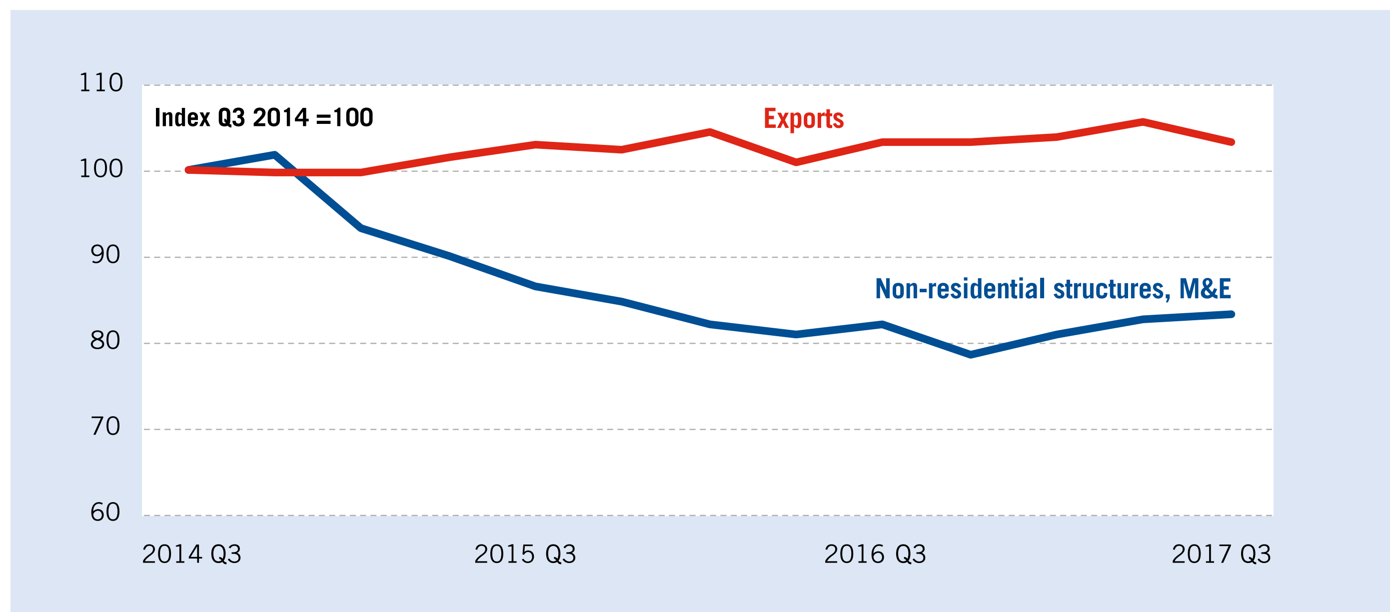
One interpretation is that firms are meeting the unexpected increase in demand for their output by expanding their labour input without the commitment implied by more capital spending. This is a rational response by firms to the uncertainty surrounding trade negotiations with the US. The Bank of Canada has stated that firms are shifting investment to the US, which is an intelligent way to hedge the uncertainty about the US commitment to free trade with Canada: if the NAFTA renegotiation talks result in the maintenance of free trade, firms can continue to freely export products from their plants in the US to Canadian markets. However, if the talks fail, firms are positioned in the US to meet demand south of the border, unfettered by restrictions at the Canada/US border.

Given the hesitancy of firms to invest in Canada, they are meeting short-term increases in demand by hiring more workers. If demand falters or the trade talks with the US fail, these workers can be shed quickly, without the long-term commitment implied by many capital investments. Canada's competitive challenge for a favourable business environment is made even greater with the anticipated passage of tax reform in the US that would reduce its statutory corporate income tax rate from 35 percent to 21 percent.

EXPORTS AND BUSINESS INVESTMENT CONTINUE TO LAG

The Canadian economy remains unable to make the transition from household spending to exports and business investment that the Bank of Canada had intended to engineer with a lower exchange rate. See chart 3 for an index of business investment and exports since 2014.

Chart 3 Business investment and exports, 2007 constant prices



Source: Statistics Canada 2017b.

Export volumes fell 2.7 percent in the third quarter, reversing all of their gains in the first half of the year and leaving exports slightly below the level of a year ago. Meanwhile, business investment in structures and equipment edged up in the quarter, but is only 0.6 percent ahead of its level a year earlier and remains nearly 20 percent below its peak in 2014 before oil prices crashed.

Auto products led the third-quarter slump in exports, as planned shutdowns for model changeovers were compounded by a labour dispute. However, the weakness in exports continued to be widespread with

declines for all types of goods except metals and aircraft. Overall, the volume of manufactured exports fell 2.7 percent in the past year, as companies have been unable to take advantage of a lower dollar and cheap oil prices.

The weakness in manufacturing continues to be most pronounced in Ontario. Manufacturing sales in Ontario fell 1.7 percent in the year to September, the only province in Canada posting a decline. Ontario is the province most dependent on exports to the US, and therefore to the increasing threats of NAFTA termination or an increasingly competitive investment climate in the US. Neighbouring Quebec posted growth of 10.2 percent, while Alberta and BC were not far behind.

> “The superior performance of the Quebec economy is noteworthy for several reasons.”

Quebec’s economy also posted a lower unemployment rate than Ontario in the most recent month, something that would have seemed impossible in the 1970s through the 1990s when unemployment in Quebec was consistently 3 to 4 points higher. The superior performance of the Quebec economy is noteworthy for several reasons. The upturn in Quebec’s growth follows several years of fiscal tightening that produced budget surpluses that the government used first to pay down its debt and now to lower taxes. As well, support for Quebec’s separatist party is near an all-time low, removing one competitive disadvantage that encouraged some people and firms to move to Ontario over the past four decades.

HOUSEHOLD SPENDING

Consumer spending remains the engine of growth, up 1.0 percent in the quarter and 4.1 percent in the past year. Even with employment and income rising, this increase in spending required households to take on substantially more debt while reducing their savings rate from 4.2 percent to 2.6 percent over the past year.

Housing demand cooled slightly for the second straight quarter, after a frenetic start to the year, especially in Toronto. House sales dipped in the Greater Toronto Area after governments introduced several measures to slow demand. The experience of Vancouver is that these measures will only temporarily slow demand. Prices in Vancouver rebounded at an annual rate of 16 percent over the past three months (Bank of Canada 2017, 10). House prices in Canada remain much higher than the fundamentals justify. For example, the OECD estimates that Canada had the highest ratio of home prices to the cost of renting housing, which is widely used as one indicator of the presence of a bubble in housing markets (2017, 73).

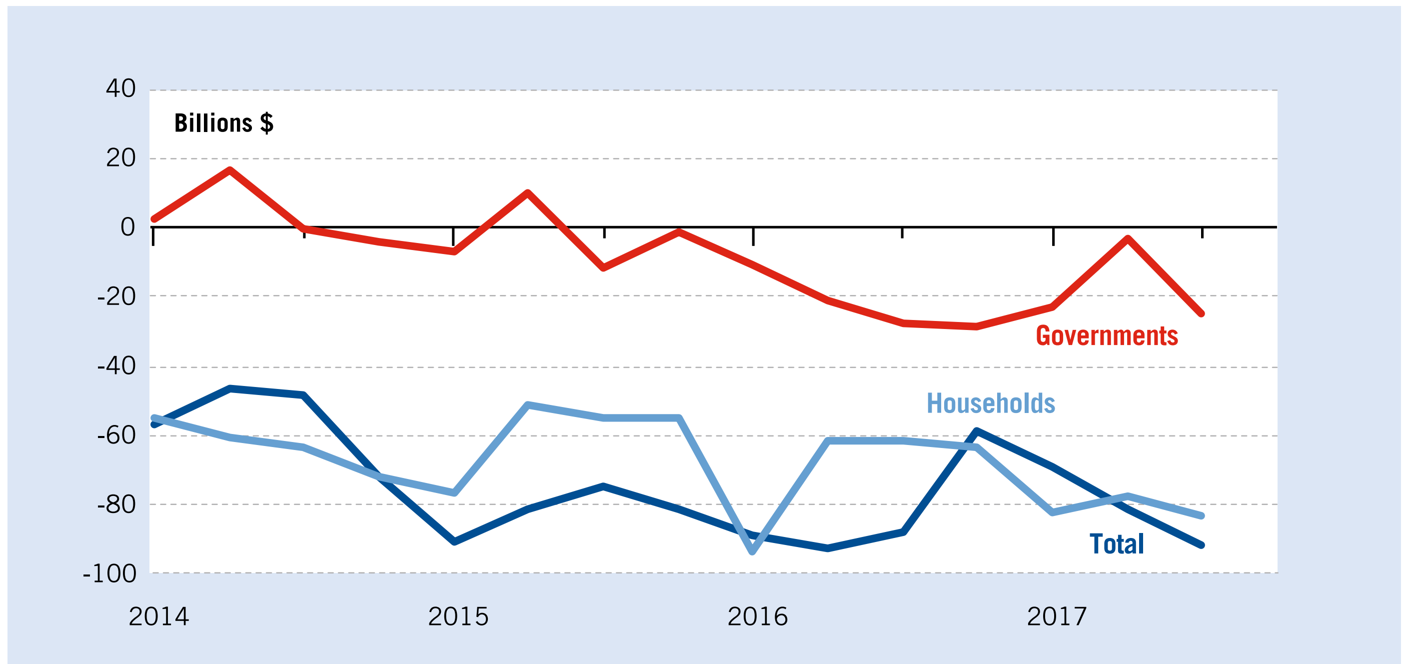
House sales are likely to accelerate sharply late in 2017, before new regulations take effect on January 1. The Bank of Canada (2017, 6) estimates that the more stringent regulations would have eliminated lending to 31 percent of all borrowers over the past year with high debt to income ratios, including nearly half in the Toronto and Vancouver markets. A report by Mortgage Professionals Canada (a mortgage-broker industry association) estimates that the new rules will force 40,000 to 50,000 homebuyers out of the market.

The Bank of Canada halted its increase in interest rates, after two hikes earlier this year, as it waits to see what impact tighter regulations have on housing demand. The Bank wants to avoid raising interest rates to cool the housing market because higher rates would boost the exchange rate and further depress exports, although this stance appears to overstate the importance of the exchange rate to exports given their lack of response to the lower dollar since 2014.

CANADIANS RETURN TO HEAVY BORROWING

Canadians had to borrow more to sustain even the tepid increase in spending in the third quarter. Net borrowing by all sectors rose nearly $10 billion to an annual rate of $91.6 billion in the third quarter, just below the recent high of $92.3 billion set in mid-2016 (see chart 4).

Chart 4 Net lending by sector



Source: Statistics Canada 2017a.

Households continued to borrow the most at $83.3 billion. The OECD (2017) issued a report last week that shows Canadian households had the highest ratio of debt to income in the OECD. The OECD also notes a feedback relationship between rising house prices and higher household debt, as "a rise in house prices increases collateral valuations, augmenting household borrowing capacity" (72). Steadily rising house prices make it seem that household net worth is not affected, but in fact they "mask households' growing exposure to a sharp fall in real estate prices" (72). The report concludes with the warning that "[e]mpirical evidence suggests that rapid growth in household debt is typically associated with negative economic outcomes such as severe recessions" (72).

Meanwhile, governments resorted to borrowing totalling $24.5 billion in the third quarter, up from just $3.0 billion in the second quarter. Most of the increase originated in the federal government and was used to finance current spending as well as increased investment. Government investment has risen by 4.1 percent in volume over the past year, far greater than business investment, as long-planned infrastructure spending has finally begun to materialize.

After a marked improvement in corporate finances late in 2016 and early 2017, business balance sheets have deteriorated despite the ongoing restraint in business investment. Corporations returned to being net borrowers in the second quarter, according to revised data, and their net lending in the third quarter remained low at $14.7 billion. Lower export prices helped depress corporate profits in the third quarter, even as rising inventories required more financing. The OECD report warning about the risks of excessive debt notes that besides the deleterious effect of house price bubbles, housing booms "also misallocate capital that would otherwise be channelled towards corporate investment, thereby slowing GDP growth" (76).

ABOUT THE AUTHOR

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