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True North in Canadian public policy

Commentary

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Canadian Economy is Running on Fumes as its Serious Slowdown Continues

Continuing weakness in business investment and exports is slowing economic growth in Canada.

Philip Cross

Overview

Canada's economy experienced a significant slowdown in the fourth quarter – one that is more pronounced than in 2015, when the economy barely managed to avoid a recession. Other advanced economies like the European Union (EU) also experienced weak growth, with the US increasingly isolated as an exception.

Business investment fell for a second consecutive quarter, largely abetted by the weak spending by the oil and gas industry. Business investment in Central Canada, notably manufacturing in Quebec, did experience a tentative recovery. And investment growth in BC remains buoyant. Yet the rebound is Ontario and Quebec is largely driven by publicly-owned utilities and urban transit, while the investment in BC reflects higher government spending. Alberta is a continuing weak spot for business investment.

Canadian exports have also experienced a slump. Oil exports remain weak due to the total lack of access to markets outside of the US and a shortage of pipeline capacity to the US. And the lower Canadian dollar has largely failed to boost non-oil exports. Consumer spending and housing demand has also fallen, though job growth remains steady for the moment – a fact that might explain why some analysts have been slow to realize the extent of this worrisome economic slowdown.

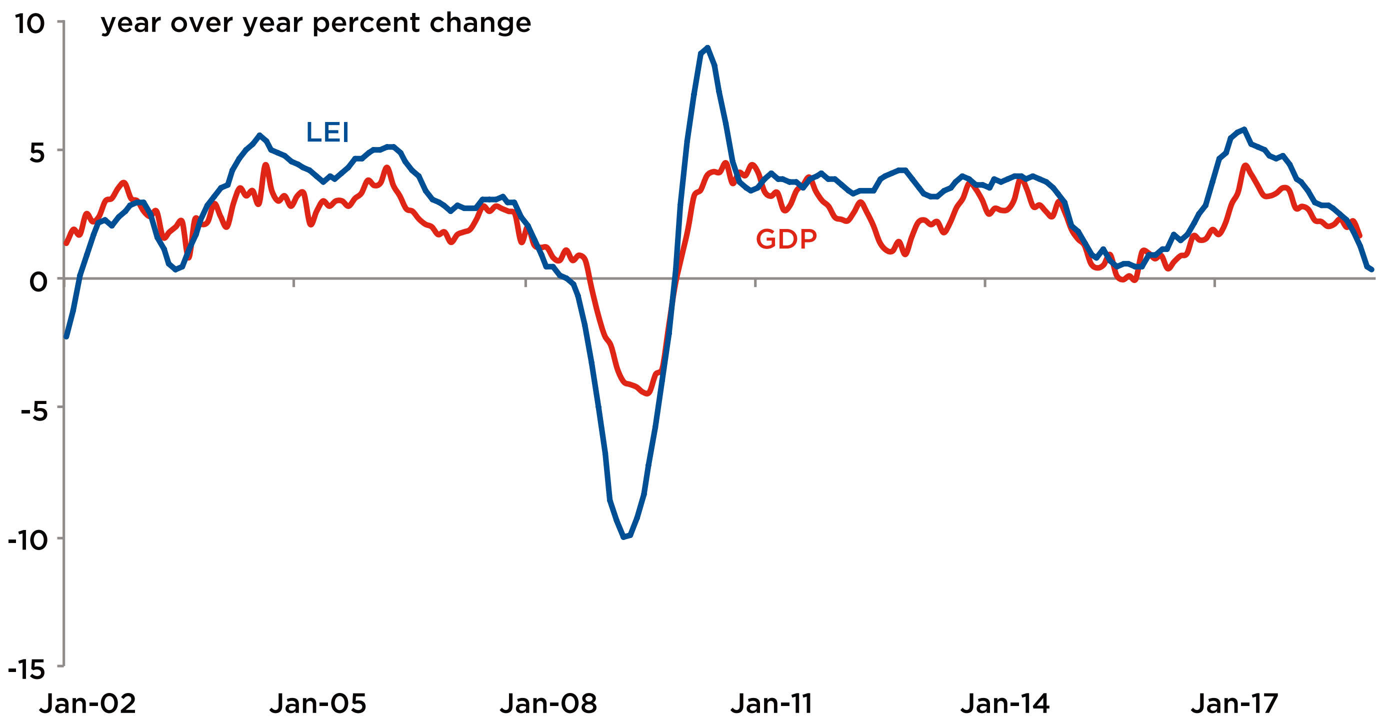
Introduction

Economic growth slowed markedly in the fourth quarter. Real GDP edged up 0.1 percent, while the dollar incomes earned by Canadians fell outright by 0.7 percent due to lower prices for Canadian exports, especially crude oil. Employment growth remained stable despite the slowdown in incomes and output.

The slowdown in economic growth extended beyond Canada. Real GDP in the EU rose by just 0.2 percent in the fourth quarter after eking out a 0.1 percent gain in the third. The United States was increasingly isolated as the main bastion of growth in the advanced market economies, with growth averaging 3.0 percent in the second half of 2018 and 2.9 percent for the year as a whole.

The outlook in Canada is for continued slow growth at best into 2019, according to the Macdonald-Laurier Institute's leading economic indicator (LEI). The LEI levelled off in January after three consecutive monthly declines. The sharp sell-off in global stock and commodity markets late in 2018 eased in January. However, the components related to manufacturing demand and consumer confidence showed no improvement early in the new year. The recent slowdown in the LEI has been more pronounced that in 2015, when the economy barely avoided falling into a recession (see Figure 1).

FIGURE 1: MLI'S LEADING ECONOMIC INDICATOR (LEI)

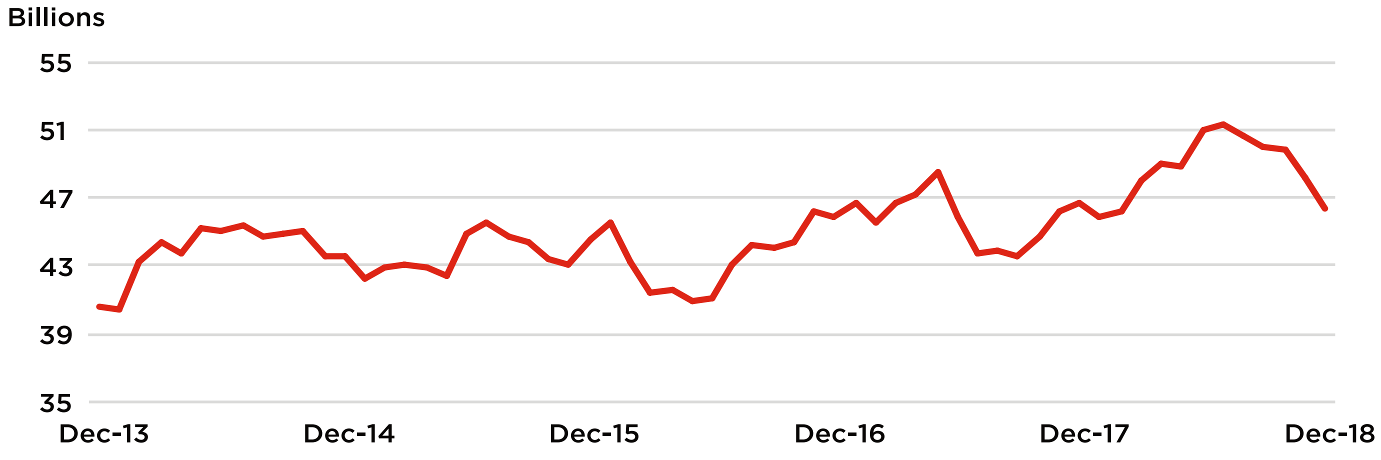


Investment drop curbs growth

In Canada, business investment fell for a second consecutive quarter. The 2.5 percent drop in the fourth quarter was the largest decline since the worst of the previous oil price slump in 2015. The decrease was widespread among buildings, engineering (which is dominated by oil and gas), and machinery and equipment.

Weak spending by the oil and gas industry remained the major factor in the weakness of business investment in the fourth quarter of 2018 (see Figure 2). According to Statistics Canada's first ever release of seasonally adjusted quarterly estimates for oil and gas investment, investment spending in this industry fell below $9.0 billion for the first time on record dating back to 2013 (see Figure 2).

FIGURE 2: OIL AND GAS INVESTMENT



Source: Cansim Table 12-10-0011-01, International merchandise trade for all countries and by Principal Trading Partners

Spending on oil and gas peaked at $21.0 billion late in 2014. After being cut in half by the oil price crash in 2015, investment recovered slightly to $11.4 billion late in 2017 as several long-planned projects in the oil sands were nearing completion. This brief upturn in the oil sands was mistakenly identified by some economists as signifying a broader rebound in business investment. Instead, oil and gas investment fell steadily through 2018 by $2.4 billion, pulling down overall business investment. Global oil prices fell sharply late in 2018, as steady increases in supply outstripped demand. The increase in supply was led by a rise in US oil output of 2 million barrels a day in 2018; by comparison, all of Canada's oil output totals about 4.5 million barrels a day. However, prices for Canadian oil fell even more sharply than global oil prices.

For all of 2018, real GDP growth totalled 1.8 percent, after gains of 3.0 percent in 2017 and 1.1 percent in 2016. The average increase of 1.9 percent over the last three years compares with 2.1 percent during the previous three years (including the near recession of 2015 during the oil price crash) and 2.4 percent between when the recovery began in 2010 and 2015. The slowdown of growth after 2015 compared with earlier periods in the recovery occurred despite the stimulus of interest cuts and a marked depreciation of the Canadian dollar and the decision of the federal government to run sizeable budget deficits after 2015.

Slower growth in 2018 reflects how the economy failed to make the transition from growth fuelled by debt-financed increases in household and government spending to growth led by business investment and exports. The Bank of Canada has hoped to engineer this transition since 2016. Household demand did slow last year, with consumer spending growth of 2.1 percent matching its slowest in the past decade while housing retreated 2.3 percent after new regulations tightened lending conditions. However, business investment spending rose by only 1.7 percent and exports volumes by 3.3 percent.

Business investment plans remain weak for 2019

Statistics Canada's annual survey of business investment intentions shows capital spending will remain weak this year. Nominal investment plans show an increase of only 3.8 percent.[1] This would leave investment 12.7 percent below its 2014 peak, after the sharp decline totalling 18.0 percent in 2015 and 2016 was followed by weak increases in each of the next three years. Spending in the mining and oil and gas industry remains the major drag on investment. After reaching $90.4 billion in 2014, outlays by this industry are projected to be just $48.2 billion in 2019.

One encouraging development in investment was a tentative recovery in central Canada, notably manufacturing in Quebec. Businesses plan a 7.2 percent increase in Quebec and a 4.8 percent increase in Ontario. Quebec's increase was led by manufacturing and, to a lesser extent, mining. The rebound in Ontario is not representative of higher business confidence, as most of the gain was driven by publicly-owned utilities and urban transit. Elsewhere, firms in Ontario remain tentative about investing more. In particular, manufacturing investment in Ontario fell sharply, which is consistent with plant closures in the auto industry.

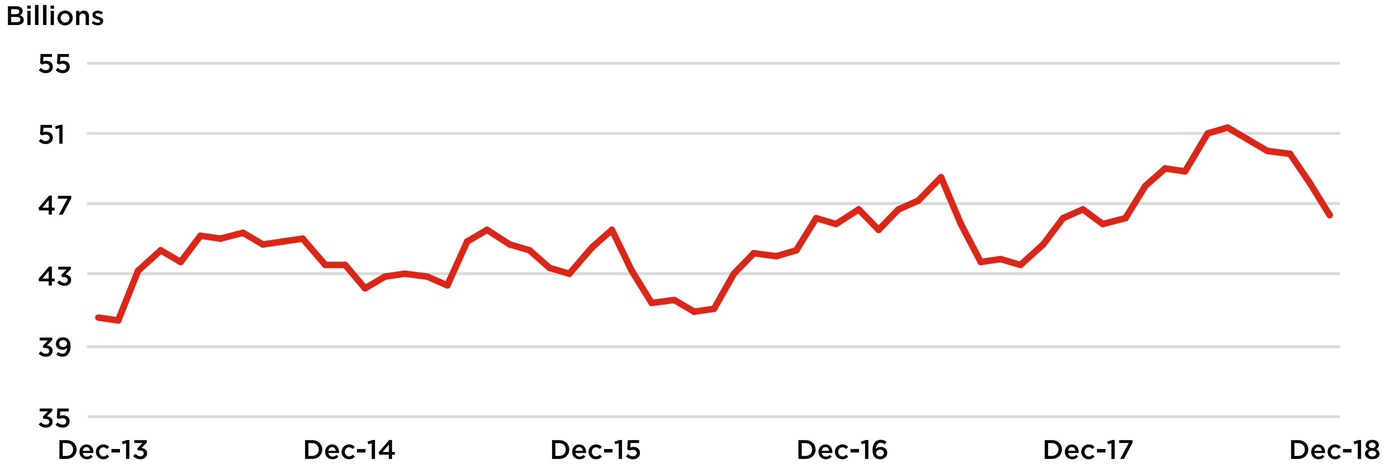
Investment growth was buoyant in BC, but this mostly reflects sharply higher government investment (which has surged by 46 percent under the NDP government) and increased spending by BC Hydro on its Site C dam project. Mining investment in BC is up slightly as work begins on high profile LNG projects. Alberta remains the weak spot for business investment, reflecting a further drop in the oil and gas sector which has fallen from $61.0 billion in 2014 to just $27.0 billion in 2019. The drop in investment in Alberta's oil and gas sector contrasts with increases in the US oil and gas industry in recent years.

> "Slower growth in 2018 reflects how the economy failed to make the transition from growth fuelled by debt-financed increases in household and government spending to growth led by business investment and exports."

Non-oil exports show stubborn weakness despite the lower dollar

Exports also have weakened significantly late in 2018, dashing hopes for a revival in this sector. Between July and December 2018, nominal exports fell 9.7 percent. Most of the retreat reflected lower prices for Canada's crude oil exports. This drop is even larger than the 5.6 percent drop in Canada's total exports during the worst of the oil price crash early in 2015 (see Figure 3).

FIGURE 3: MERCHANDISE EXPORTS



Source: Cansim Table 12-10-0011-01, International merchandise trade for all countries and by Principal Trading Partners

There are two parts to the underlying weakness of Canadian exports since 2014. The first is the decline in oil exports. Their slump in 2015 reflected lower global oil prices as OPEC tried to flood the market and limit the inroads made by competition from sources such as Canada's oil sands and shale producers in the US. However, the most recent slump mostly reflects lower prices for Canadian oil more than prices on world markets, as the price of Canadian bitumen was pulverized by a total lack of access to markets outside of the US and a shortage of pipeline capacity to the US.

Over the year ending in November 2018, crude oil production in Canada rose 6.2 percent, entirely due to an increase in the oil sands as conventional crude oil production fell (oil sands extraction accounted for 71 percent of Canada's crude oil output in November). Most of this increase was exported to the US, with shipments by pipeline up 15.5 percent but exports by other means (mostly rail) soaring 45 percent as firms tried to work around a lack of pipeline capacity to the US (Statistics Canada 2019).

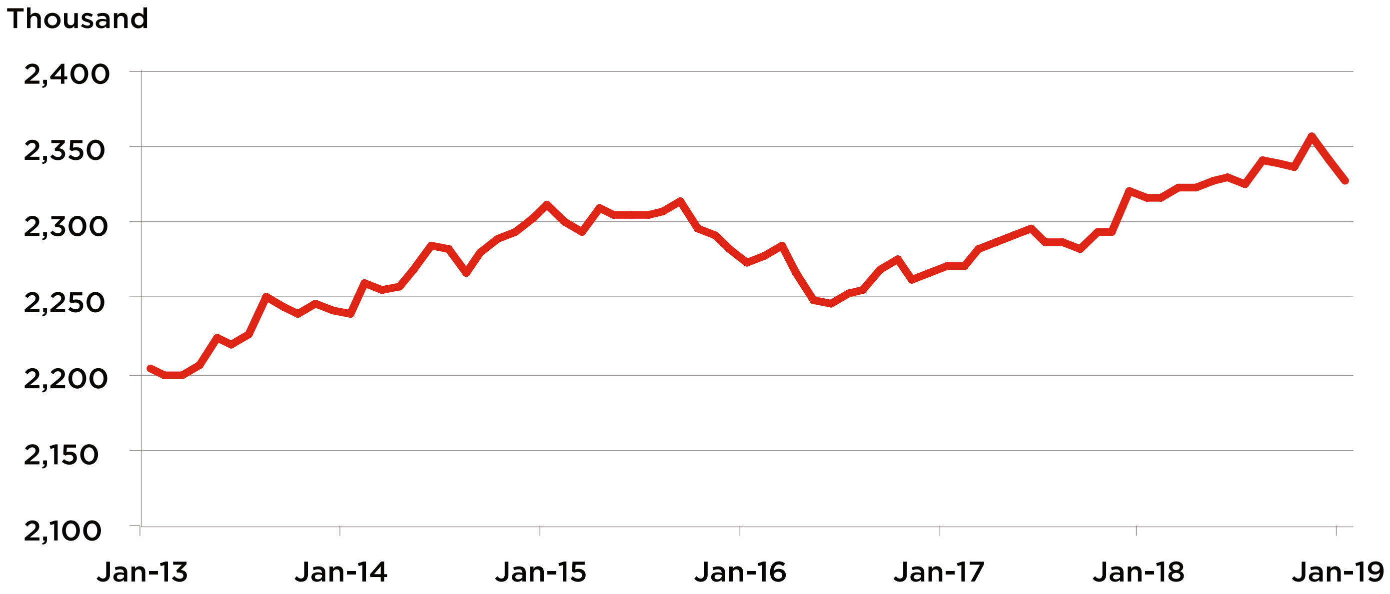
The lack of pipeline capacity was aggravated by further delays to the construction of the Keystone pipeline extension and the Line 3 pipeline to the US at a time when output from the oil sands was increasing sharply. With rising supplies and only a limited number of refineries in the US able to process bitumen, the price of Western Canadian Select oil reached a record low in November 2018. The Bank of Canada noted that bottlenecks in transportation capacity also affected Canadian oil prices besides Western Canadian Select (Bank of Canada 2019, 9). The rising tide of crude oil export volumes accounted for half the 3.3 percent increase in overall export volume in 2018.

The second part of the story of weak exports concerns why non-oil exports have not responded to the lower Canadian dollar. Initially the Bank of Canada expected non-oil exports to respond robustly to the lower dollar. The Bank of Canada has changed its narrative on why Canadian non-oil exports have struggled despite the lower exchange rate. At one point, the Bank speculated that the weakness reflected supply constraints reflecting the destruction of manufacturing capacity when the Canadian dollar was rising between 2003 and 2008. However, there was never more than limited anecdotal evidence to support this hypothesis. More recently, Bank of Canada research has pinpointed demand such as "competitive challenges" and not supply factors as the cause of the slump in non-oil exports (Dorich, Lepetyuk, and Swarbrick 2018).

Employment firm but household income and spending slow

One reason analysts were slow to realize how fast the economy was slowing through 2018 was the steady growth of employment. Overall job growth in Canada was 0.5 percent in the fourth quarter after a 0.3 percent gain in the third. There are several reasons why employment might continue to grow even as GDP slows. Alberta in 2015 is a vivid example of how, after a period of intense labour shortages, employers for months delayed shrinking their payrolls even after the economy had clearly turned down late in 2014 (see Figure 4). Employment did not actually begin to contract until September. A similar concern about shortages in central Canada may explain why firms are retaining their employees despite slower demand. As well, the election of pro-business regimes in Quebec and Ontario may have encouraged firms to hire more. Ontario, for example, cancelled another hike in its minimum wage scheduled for January 1, 2019.

FIGURE 4: EMPLOYMENT IN ALBERTA



Source: Statistics Canada, CANSIM Table 14-10-0287-01

Comparing GDP and employment growth for all of Canada shows that GDP growth has varied widely between 1 percent and 4 percent since the recovery began in 2009 while jobs growth has varied mostly between 1 percent and 2 percent. On at least two occasions, in 2013 and late in 2015, year-over-year GDP growth slipped below employment growth.

Whatever the reasons for steady employment, households are taking their cue for spending from their incomes and not job growth. Over the last four quarters, disposable incomes rose by 2.2 percent, barely keeping up with inflation. As a result, consumer spending slowed in 2018 and housing demand fell outright. The pressure on household finances was evident in the personal saving rate, which fell from 2.3 percent at the end of 2017 to 1.1 percent by the end of 2018 despite the slowdown in consumer spending. The stagnation of real incomes in 2018 occurred despite sharp increases in minimum wages in several provinces (notably Ontario and Alberta) with the expressed goal of boosting household incomes.

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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Endnotes

1 Business investment is calculated as total spending on non-residential structures and equipment, excluding the education, health care and public administration industries which are dominated by government.

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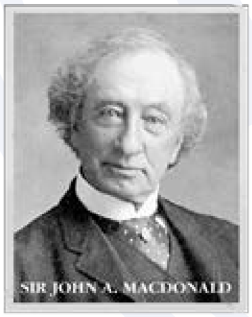

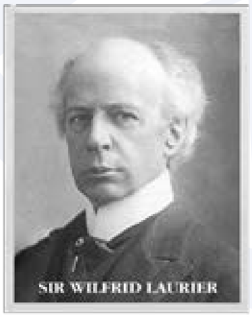

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