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Commentary

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Upturn In Economic Growth Is Unsustainable

Canadians may think their economy is booming. But the slowdown in manufacturing and housing sectors points to serious problems on the horizon.

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Highlights

Canada's economic growth rate in the last quarter has surpassed the expectations of many observers, leading some to go so far as to say we are in the midst of an "already-sizzling economy" (Blatchford 2017). Such hyperbole is both inaccurate and unhelpful.

In terms of real GDP, Canada's economy expanded by 1.1 percent in the second quarter, a modest improvement over the 0.9 percent increase in the first quarter. Growth was also primarily driven by two factors: autos and energy. The Macdonald-Laurier Institute's (MLI) leading indicator raises doubts on the sustainability of such growth. In fact, the index has more recently slowed to 0.2 percent growth or less in the last three months, especially in the manufacturing and housing sectors, which points to the serious challenges on the horizon.

The Bank of Canada began to raise interest rates for the first time in seven years. Low interest rates were intended to encourage an upturn in exports and business investment, which would lay the groundwork for more sustainable growth. Lower interest rates did help to facilitate household and government debt. Yet its beneficial impact on either exports or business investment remains elusive.

Most of the recent increase in exports largely originated in energy products (up $10.3 billion) and autos (up $4.8 billion). The former can be attributed to a tentative recovery in the oil and natural gas sector, the latter driven by inventory-building in the US before long-scheduled production cut. Without an acceleration in US economic growth, further increases are not sustainable.

Meanwhile, business investment rose 1.7 percent in the second quarter, following a 3.3 percent recovery in the first. Oil and gas spending led the turnaround, rising 15 percent from a year earlier. Yet the durability of this recovery can be questioned. Investments in the oil sands are winding down, with several major projects have or are nearing completion and no prospect of new investments for the foreseeable future. Much of the gain apparent gain in the first quarter to $165.1 billion simply represented a return to more normal levels of investment after the impact of the Hebron oil platform came and passed in 2016.

Further slowing the economy has been the unwinding of the three-year boom in Canada's housing market, which began in the second quarter after the average price of a house reached nearly $1 million in both Vancouver and Toronto. Both the BC and Ontario governments slapped taxes on home purchases by foreign buyers, which led to a one-time drop in demand. The Bank of Canada's move to raise interest rates will start to curb demand on an ongoing basis, including the negative impact of a higher dollar on foreign buyers.

Overview

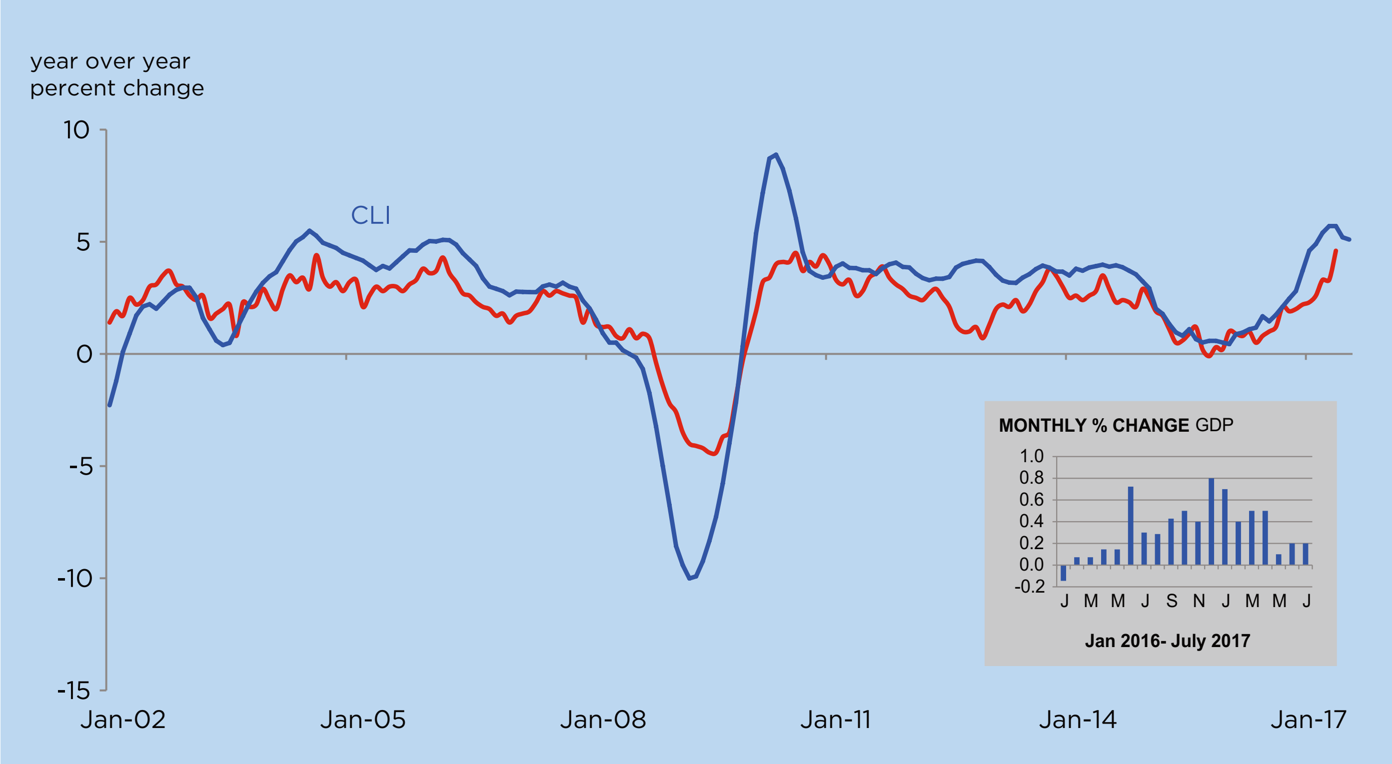
The Canadian economy continued to surpass expectations, with real GDP expanding by 1.1 percent in the second quarter after a 0.9 percent advance in the first. However, incomes did not fare as well, since lower export prices pulled down incomes by 0.4 percent. Higher output and lower prices were connected, as exporting increasing amounts of crude oil depressed the price it received in the US market.

> "Several factors help explain why the upturn of growth in the first half of the year did not represent the long hoped for break out of growth from its long-term stagnation since 2009."

Several factors help to explain why the upturn of growth in the first half of the year did not represent the long hoped-for break out of growth from its long-term stagnation of about 2 percent growth in every year since 2009 (excluding the oil bust in 2015 when growth dipped below 1 percent). Growth was buttressed by inventory building in the auto industry on top of the end of cost-cutting in the oil sector. Broadly speaking, the increased growth in the first half of 2017 was the mirror image of the slump in growth in the first half of 2015. At that time, the shutdown of auto plants in Canada for extensive retooling was the main drag on GDP, which fell marginally over the first two quarters, compounded by the deepening slump in the oil industry. The lesson of both 2015 and 2017 is that Canada's $2 trillion economy is still small enough to be significantly affected by the actions of one or two of its leading industries, which may not reflect the underlying course of the total economy.

The MLI's leading indicator clearly points to the unsustainability of the upturn of growth (see graph 1). After a peak rate of increase of 0.8 percent late in 2016 that presaged the buoyant performance in the first two quarters of 2017, the index slowed to 0.2 percent growth or less in the last three months. Most of the slowdown originated in the housing and manufacturing sectors, which had led growth in the first half of the year. Housing already is reeling from several steps taken to cool Toronto's overheated market, including the Bank of Canada's first hike in interest rates since 2000. Meanwhile the auto industry implemented long-planned shutdowns starting in July.

Graph 1: MLI Leading Economy Indicator, 2002-2017



Debt again fuels higher spending

Besides industry specific anomalies behind the first-half surge in growth, higher spending continues to be financed by debt, notably households and governments. With Canadians spending more than their income (whose growth was dampened by lower prices), the difference continued to be met by increased borrowing abroad. As recently as the third quarter of 2016, all three sectors of domestic spending (households, businesses and governments) were net borrowers, totalling $92 billion (at annual rates). The end of the downturn in the oil and gas industry allowed the business sector to stop borrowing this year. However, households and governments continue to run large deficits, and domestic borrowing remained elevated at $80.4 billion in the second quarter. Some of this debt was denominated in foreign currencies, notably for provincial governments, which becomes more onerous if the exchange rate falls (on top of rising interest rates).

It is worth reflecting on why the Bank of Canada began to raise interest rates for the first time in seven years. Publicly, Bank of Canada's Governor Stephen Poloz said that rates were hiked because lower rates had "done their job." The pick up in growth superficially supports this sentiment. However, recall that the Bank for years had said that low interest rates were intended to encourage an upturn in exports and business investment that would lay the groundwork for more sustainable growth. Specifically, the surprise cut in interest rates early in 2015 had the hoped for effect of lowering the exchange rate. However, even as interest rates and the exchange rate fell, the expected rebound in exports and business investment remains elusive – the only partial exception being the end of the downward spiral in the oil and gas sector. Instead, lower interest rates seem to have encouraged households and governments to continue to borrow and spend more, without inducing the increase in sectoral demand as the Bank had hoped. In fact, the July increase in interest rates is simply a belated move to curb the over-heated housing markets in Toronto and Vancouver.

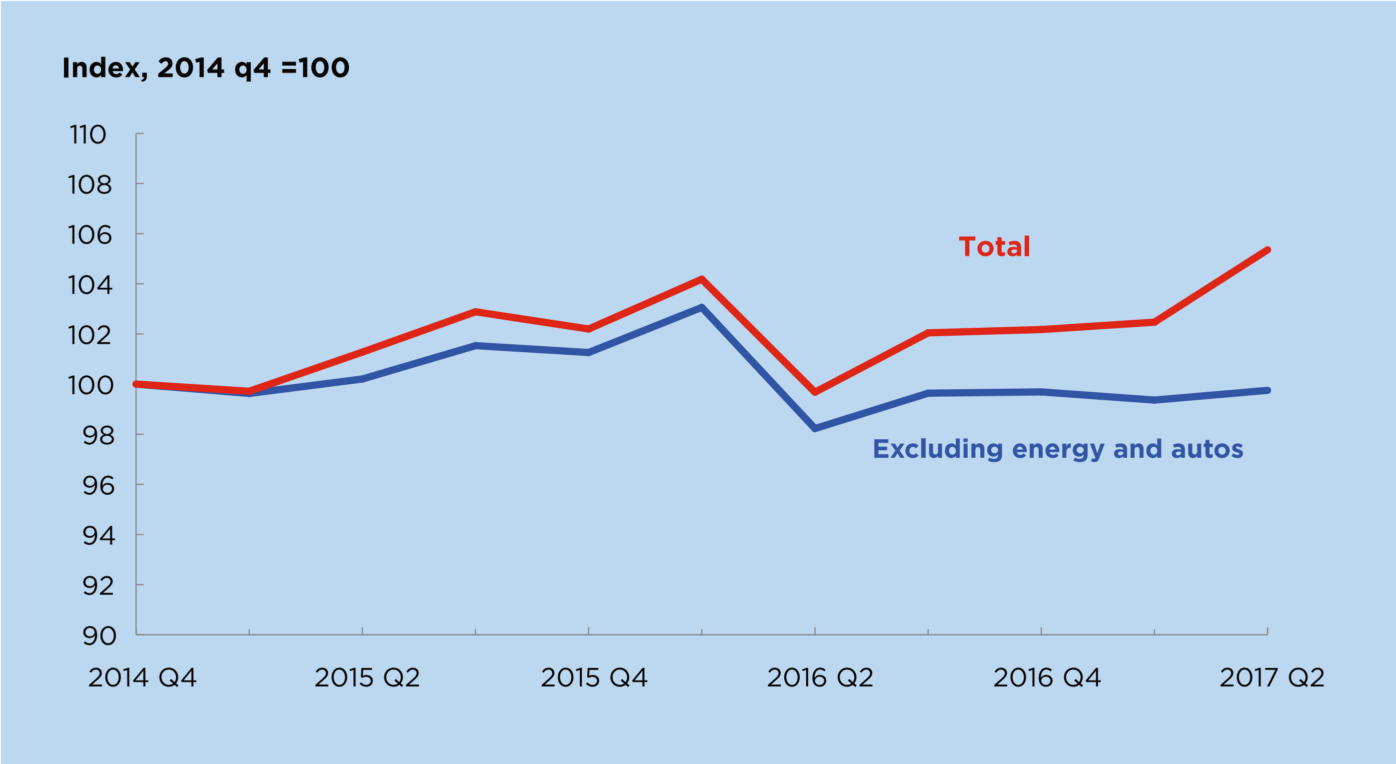
Manufacturing exports remain weak

Manufacturing exports continued to struggle in the first half of 2017. Virtually all of the $15.3 billion increase in the volume of goods exports in the first half of the year originated in energy products (up $10.3 billion) and autos (up $4.8 billion). The upturn in energy products mostly reflected the recovery in oil and especially natural gas. The increase for autos was driven by inventory-building in the US. If one excludes energy and autos, exports have shown little to no growth since 2016 (see graph 2).

There is also reason to be pessimistic about the auto sector in particular. Inventory-building of autos in the US was done prior to production being cut in the third quarter, due to the permanent closing of one line in General Motors' Cami plant and extensive shutdowns for retooling for new models. The US auto industry normally holds the equivalent of about 70 days of sales in inventory; General Motors planned to raise this to 90 days to cope with the third quarter plant closures, but weak sales in the US resulted in inventories rising to 105 days (US auto sales fell 3.8 percent in the first quarter, 2.3 percent in the second and another 2.3 percent in July and August). This is clearly not a sustainable source of growth, especially with plans underway to cut North American production by 150,000 vehicles in the second half of 2017 (Carey and White 2017).

Exports of non-auto manufacturing goods continued to weaken in the first half of 2017. Declines were posted for industrial chemicals, rubber and plastics, forestry products (mostly pulp and paper), electronic products, aircraft and consumer goods. Industrial machinery was the sole exception to the widespread weakness in manufacturing exports. Bank of Canada's Deputy Governor Carolyn Wilkins (2017) offered no explanation of this weakness other than to say: "We have been working hard to understand the forces behind the data" on exports.

Graph 2: Exports of Goods - Total and excluding energy and autos, 2014–2017



Source: Statistics Canada 2017b

Weak manufacturing exports were reflected in the regional dimension of Canada's growth. Despite the temporary boost in its auto industry, Ontario's manufacturing sales continue to lag behind the national average. And despite the extraordinary boom in Toronto's housing market, employment in Ontario grew only 2.0 percent in the past year, below the national average and far behind the 3.0 percent in neighbouring Quebec. The sluggish labour market in Ontario was reflected in lagging wages, as average weekly earnings rose only 1.1 percent in the past year.

Exports will continue to struggle in the absence of an acceleration in growth in the US economy. There are few signs that is happening. Real GDP growth in the past four quarters rose by 2.2 percent, little changed from its average annual gain of 2.1 percent since 2009. Employment growth slowed from an average monthly gain of 0.2 percent late in 2015 to 0.1 percent over the past year. The buoyancy that the prospect of a new US President lent to financial markets and to consumer confidence is dissipating as legislation stalls in Congress and the administration continues to squabble among itself.

In addition, exports will be restrained by a recovery of the exchange rate in the third quarter. The Canadian dollar plumbed to a low of 73 cents (US) during the second quarter at a time when unfounded concerns about our financial system reinforced lower commodity prices. The concerns were fuelled by an across the board downgrade of the debt issued by Canada's large banks as well as the well advertised problems at a Toronto-based mortgage dealer (which were subsequently funded by Warren Buffett, buttressing confidence in the financial system). With oil prices also recovering, the dollar quickly rallied to above 80 cents (US) over the summer.

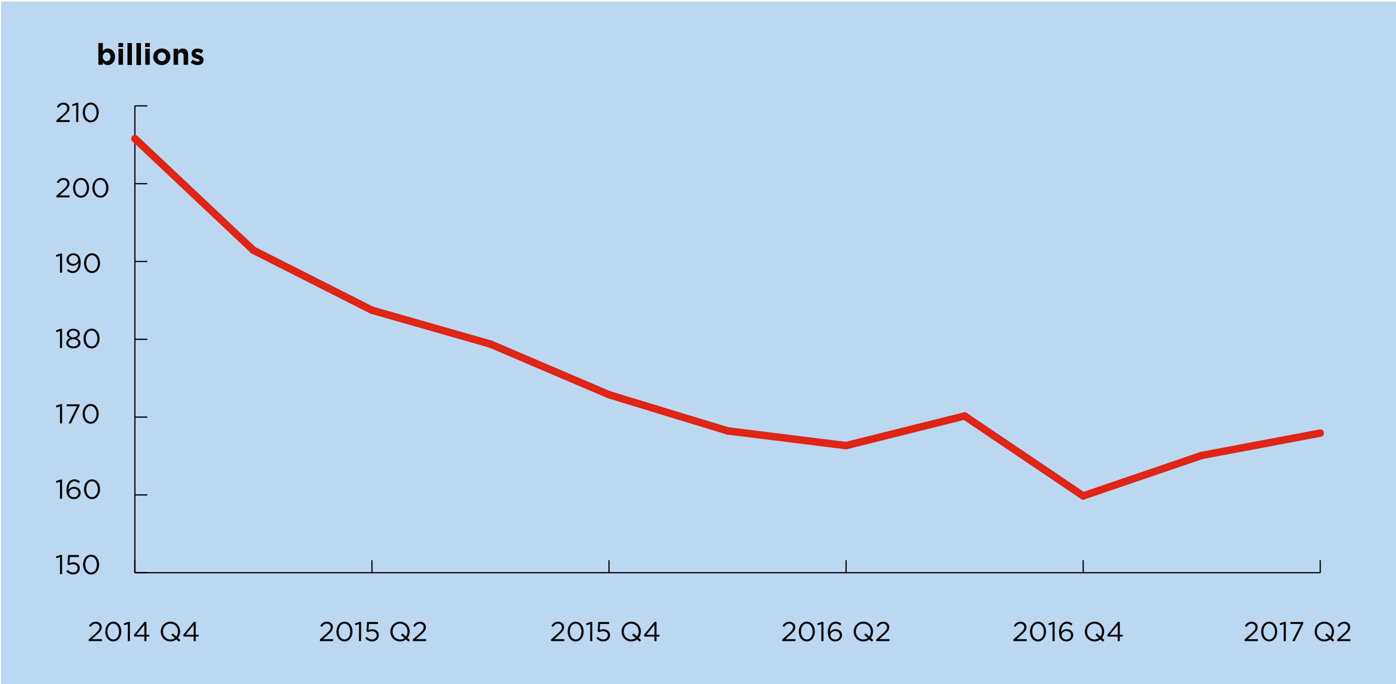
> "The apparent recovery of business investment is even more shallow than for exports."

Business investment recovery is slow

Business investment in plants and equipment rose 1.7 percent in the second quarter, after a 3.3 percent recovery in the first. Oil and gas spending led the turnaround, rising 15 percent from a year earlier after steep declines over the previous two years.[1] The durability of this recovery is open to question, as exploration and development for oil and gas in May and June gave back some of its gains. Meanwhile, investments in the oil sands are winding down as several major projects have or are nearing completion, with no prospect of new investments to take their place in the foreseeable future.

The apparent recovery of business investment is even more shallow than for exports (see graph 3). Investment in the first half of the year was concentrated in the oil and gas industry after two years of severe cuts. As well, investment was artificially inflated in the third quarter of 2016 by the arrival of the main drilling platform for the Hebron offshore project, which pushed investment spending on plant and equipment to $170.1 billion (at annual rates). With the passing of this one-time event, investment spending plunged to $160.0 billion in the fourth quarter. As a result, much of the apparent gain in the first quarter to $165.1 billion simply represented a return to more normal levels of investment. Business investment remains quite weak by historical standards; at $167.9 billion in the second quarter, it remains little changed from the level of a year ago and well below the $208.8 billion posted just before the boom in the oil and gas sector ended late in 2014.

Graph 3: Real Business Investment, 2014–2017



Source: Statistics Canada 2017c

Another quixotic result is the juxtaposition of rising business investment and faltering government investment spending, which has barely increased this year. Some of this reflects that government spending on urban transit, which is significant in several major cities, is classified to the business sector in the National Accounts. However, Statistics Canada only receives data on the classification of investment spending to the government and business sectors once a year, and so some of the recent increase in its quarterly estimate of business investment could eventually be revised and attributed to the government sector.

The housing boom starts to unwind

The 3-year boom in Canada's housing market began to unwind in the second quarter after the average price of a house reached nearly $1 million in both Vancouver and Toronto. House prices in both cities took off early in 2015 due to the confluence of three inter-related factors. The first was the drop in interest rates engineered by the Bank of Canada. The second was the devaluation of the Canadian dollar that began with plunging oil prices but which the Bank of Canada artfully encouraged with its surprise cut in interest rates. This resulted in foreign home buyers receiving a sharp jump in their purchasing power, since their currency now bought 20 to 25 percent more Canadian dollars. Finally, the end of the boom in Alberta meant that the flow of population from Vancouver and Toronto to Alberta came to a halt and even was partly reversed. In particular, the inflow of immigrants to Vancouver and Toronto no longer used these cities as a temporary way station on their way to the booming oil-producing provinces but became their final destination in Canada.

Governments introduced a number of measures to cool their housing markets by addressing some of these three causes. In particular, the BC (in 2016) and Ontario (spring 2017) governments slapped taxes on home purchases by foreign buyers. The measures had an immediate impact, lowering national house prices by 22.3 percent between March and July. BC's experience over the past year suggests that this leads to a one-time drop in demand as a segment of foreign buyers moves elsewhere, but does little to alter the fundamentals of the housing market.[2] The Bank of Canada's move to raise interest rates will start to curb demand on an ongoing basis, including the negative impact of a higher dollar on foreign buyers. However, population flows to the oil-producing provinces are unlikely to resume for some time as oil prices remain weak. This suggests immigrant inflows will continue to be concentrated in Vancouver and Toronto.

Conclusion

Skepticism about the endurance of the first-half growth surge is widely-held. Despite the better than expected start to 2017, the consensus growth forecast for the next two years is a return to the 2 percent or less that has gripped Canada's economy most of the time since 2009. Examining the sources of growth in the first half of 2017 reinforces this skepticism. The acceleration of growth was driven by energy and autos, the same industries that depressed growth in the first half of 2015. Sustaining higher growth in Canada is nearly impossible without an acceleration in the US, and there are few signs that is occurring. With incomes weakened by a drop in export prices and a reversal in housing, Canadians sustained higher spending by continuing to borrow more.

The hoped for rotation from household spending to business investment and manufacturing export continues to sputter. Already, exports in July fell 5 percent, matching their retreat in June and reversing all of the gains made earlier in the year. Nevertheless, the Bank of Canada raised interest rates early in July, helping to cool an over-heated housing market while pushing the exchange rate past 80 cents (US). This dampening of housing and exports will hamper growth in the second half of the year, in accordance with the slowdown in the MLI's leading indicator.

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Endnotes

1 The data for oil and gas are not seasonally adjusted. See Statistics Canada 2017a.

2 The Bank of Canada noted this impact for Vancouver, saying “we saw the market cool for a period of time. But it is picking up again” (Wilkins 2017, 5).

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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