



True North in  
Canadian public policy

# Commentary

JUNE 2018

## Why the American Economy is Hot, and Canada's is Not

*Investment in the US reflected in superior economic performance compared to Canada*

Philip Cross

### Overview

Business investment in the US is improving faster than in Canada. The Trump administration has signalled its desire to improve the business climate in various ways, from reducing regulations to sharply lowering the corporate income tax. Meanwhile in Canada, several jurisdictions are doing the opposite. Overhanging all this is uncertainty on the NAFTA renegotiations. Firms have an incentive to invest in the US; if talks fail, they have a beachhead in the US from which to produce for the US market. If talks succeed, they can export freely to Canada across the border.

This contrast is mirrored in the superior performance of the US economy. Canada's economy continued to slow early in 2018. Real GDP growth eased to 0.3 percent in the first quarter, as slumping housing demand reinforced weak non-energy exports. Consumer spending also slowed as employment fell by 50,000 people in the first three months of the year. In contrast, real GDP growth in the US reached 0.5 percent in the first quarter, while its year-over-year growth picked up to 2.8 percent as business investment strengthened noticeably. Lower growth in Canada is also notable because its indebtedness continues to swell, but without stimulating growth.

Furthermore, the US added nearly one million new jobs, with unemployment having fallen to 3.8 percent. This can be compared with a 4.8 percent unemployment rate in Canada, with job losses being particularly noticeable in British Columbia and Ontario. In BC, the new NDP government's unrelenting opposition to the

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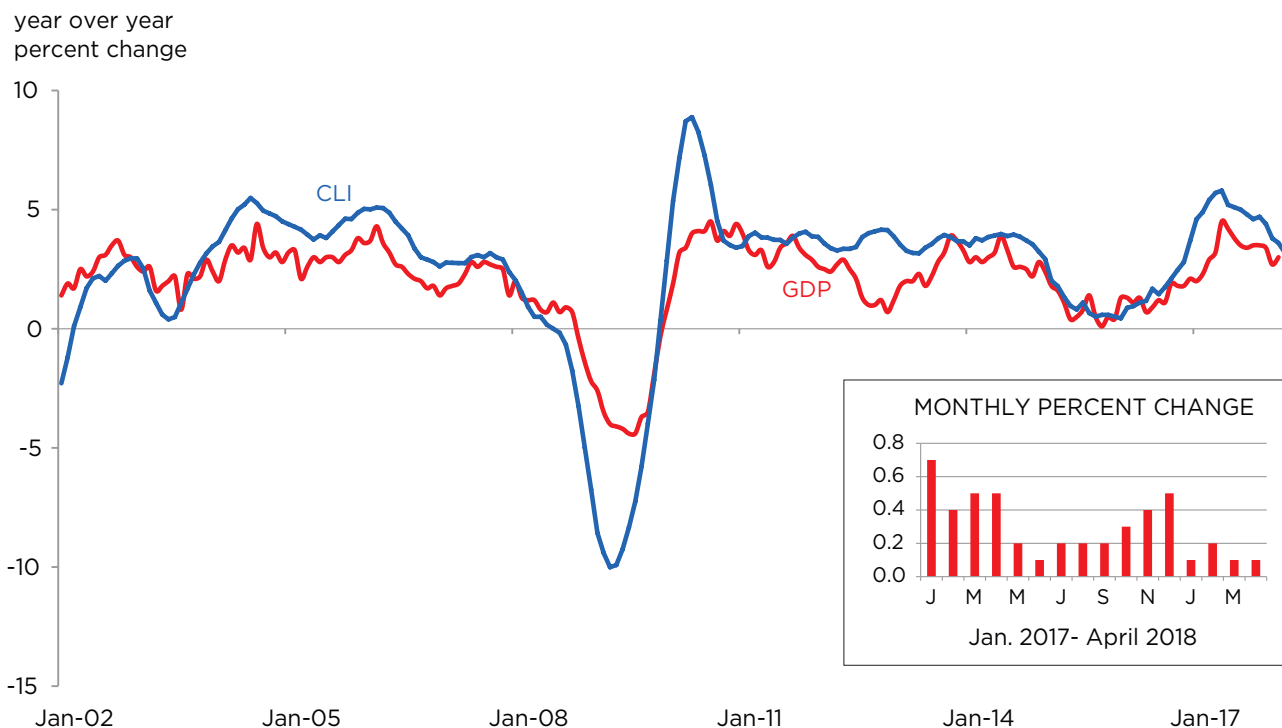
Trans Mountain Pipeline helped raise the level of uncertainty surrounding business investment in Canada. Meanwhile, the Ontario government passed an increase to the minimum wage on January 1, although benefits of this wage increase have been largely offset by job losses in the first quarter.

## Introduction

The Canadian economy continued to post slow growth, with real GDP rising by only 0.3 percent in the first quarter on the heels of back-to-back gains of 0.4 percent in the second half of 2017. Overall growth has slumped below a 2 percent annual rate since the first half of 2017, when the economy received unusual boosts from auto production before model changeovers just as the Toronto housing market peaked. While the oil industry has recovered, this has been offset by continued weakness in non-energy exports and a marked slowdown in housing. As well, consumer spending growth is less than half its pace of a year-ago, reflecting lower employment.

The return of the Canadian economy to sluggish growth is projected to continue by MLI's leading economic indicator. In April, the index slowed further from 0.4 percent to 0.3 percent, as the slump in the housing index deepened for a fourth straight month after new regulations on mortgages took effect on January 1. As well, financial market conditions continued to deteriorate and the Bloomberg index of consumer sentiment weakened. The index was buoyed by growth in the US economy and higher commodity prices (see chart 1).

**Chart 1: MLI Leading Economic Indicator, 2002-2017**



While many analysts were caught off guard by the slowdown of the Canadian economy that began in the second half of 2017 and is continuing this year, the MLI leading index presaged a deceleration. By June of 2017, the growth of the index already had slowed markedly to just 0.1 percent. Since then, growth has remained weak at just 0.1 or 0.2 percent a month, apart from a brief pick-up late in 2017 as homebuyers rushed to purchase homes before stricter lending regulations took effect on January 1, 2018.

## Business investment is reviving in the United States while Canada lags

Perhaps most striking in comparing the performance of the Canadian and the US economies in 2018 is the difference in investment intentions. Statistics Canada found in its annual comprehensive survey that firms here plan to trim investment outlays by 1 percent, their fourth straight annual decline. Meanwhile, the Purchasing Manager's Index semi-annual survey of investment intentions in the US (Institute for Supply Management 2018) found that manufacturing firms revised up their investment spending from a 2.7 percent increase just six months ago to 10 percent, while non-manufacturing firms raised spending plans from 3.8 percent to 6.8 percent. The forecast of an upturn in business investment in the US is reflected in actual spending, as business investment in the first quarter was up 6.8 percent in volume from a year earlier, nearly double the 3.5 percent increase in the previous year.

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It is not difficult to identify the reasons why business investment in the US is improving faster than in Canada. The Trump administration has been unrelenting in signalling its desire to improve the business climate, from reducing regulations to sharply lowering the corporate income tax. Meanwhile in Canada, several jurisdictions are doing the opposite, by sharply raising the minimum wage in a short period and blocking the construction of pipelines that have already met all the necessary regulatory approvals (as in BC). Overhanging all this is uncertainty about the outcome of the NAFTA renegotiations, which gives firms an incentive to invest in the US; if talks fail, they have a beachhead in the US from which to produce for the US market. If talks succeed, they can export freely to Canada across the border. In such an environment, it is not surprising to see the US administration resisting Canada's "progressive" trade agenda, since continued uncertainty may actually favour the US while harming Canada.

The contrast between buoyant business investment in the US and weak investment in Canada is mirrored in the superior performance of the broader US economy. Real GDP growth in the first quarter of 0.5 percent in the US surpassed Canada's 0.3 percent gain, while the year-over-year increase in US GDP reached 2.8 percent. While the underlying annual rate of growth in the US is approaching 3 percent, in Canada it has fallen to half that since mid-2017, lower than before the oil slump began in 2014 despite the addition of large amounts of both fiscal and monetary stimulus. While jobs in Canada have declined by 50,000 people (or 0.3 percent) overall since December, the US has added nearly one million new jobs. As a result, measured on the same basis, unemployment in the US has fallen to 3.8 percent compared with 4.8 percent in Canada.

Canada's slowdown in jobs was particularly pronounced for British Columbia. After leading the nation in job growth for two consecutive years, employment in BC fell by 0.5 percent since last June. This stall accompanied

the arrival of a new NDP government, whose unrelenting opposition to the Trans Mountain Pipeline helped raise the uncertainty surrounding business investment in Canada, to the point that the federal government had to buy the project for \$4.5 billion to keep it viable. More recently, Ontario has shed jobs since the start of the new year, mostly in January when the minimum wage hike took effect.

Inventories continue to rise faster than sales in the Canadian economy. The economy-wide ratio of inventories to sales reached 0.765 in the first quarter, its highest level since 2009 when it stood at around 0.70. Stock-building was most marked in manufacturing and wholesaling. While stock-building in the first half of 2017 was a deliberate strategy in the auto sector in anticipation of lower production during model changeovers, the continuation of rising inventories in recent quarters appears related to slower sales. This may subtract from growth in future quarters as firms re-align inventories with sales.

## Canada continues to borrow more to sustain spending

High borrowing continues to buttress higher spending in Canada. Net borrowing by all sectors of the economy totalled \$88.0 billion (at annual rates) in the first quarter, up from \$68.3 billion a year earlier. Total borrowing by all governments in Canada rose from an annual rate of \$25.7 billion to \$34.7 billion over the past year. The cooling of the housing market was reflected in a drop in household borrowing from \$83.1 billion a year ago (when the frenzy in Toronto's housing market reached its peak) to \$67.2 billion in the first quarter of 2018. The surplus in the business sector was reduced by the rebound in investment in the oilpatch and lower profits.

The Bank of Canada's semi-annual Financial System Review identified household indebtedness and imbalances in the housing market as the key vulnerabilities in Canada's financial system. Household borrowing growth has slowed since last spring, reflecting tighter regulations of mortgages and lower house prices in Vancouver and Toronto. The impact of mortgage interest stress tests introduced on January 1 has not been fully felt by the housing market, as mortgages pre-approved before January 1 can still be used to make purchases in 2018 (Bank of Canada 2018, 6).

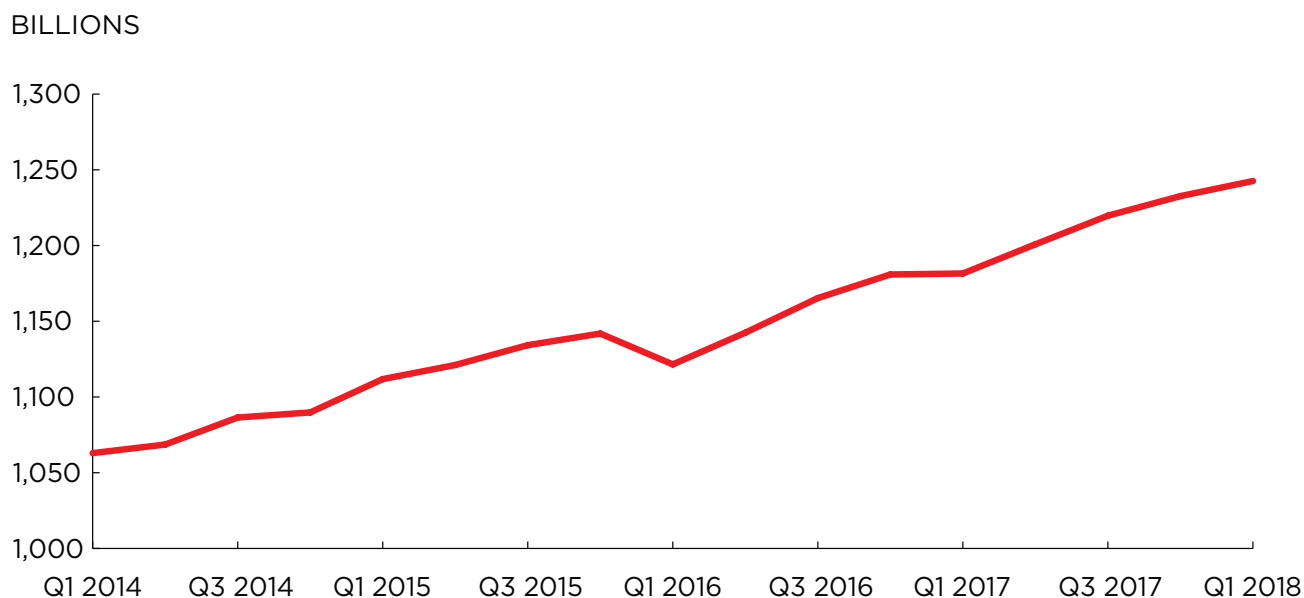
“ High borrowing continues to buttress higher spending in Canada.

## Disposable income growth little changed by government action

Disposable incomes only rose by 0.8 percent in the first quarter, despite a sharp increase in the minimum wage in Ontario on January 1, which was supposed to give a major lift to incomes. While wage rates did increase as a result, this boost to incomes was largely offset by job losses in Ontario in the first three months of the year.

Personal disposable incomes have grown steadily at about 5 percent in recent years irrespective of large government initiatives intended to boost growth. In the year between the first quarter of 2014 and the first quarter of 2015, disposable incomes grew by 4.6 percent. Incomes did slow during the worst of the oil crash in Alberta in 2015. Then growth resumed, totalling 5.4 percent between the first quarter of 2016 and the first quarter of 2017, a period when the federal government expanded the Canada Child Benefit. Over the last four quarters, income growth actually slowed slightly to 5.2 percent even with the minimum wage hike in Ontario (see chart 2).

**Chart 2: Disposable income in Canada, quarterly, 2014-2018**



*Source: Statistics Canada CANSIM Table 380-0073*

Despite these gains, real consumer spending growth slowed from an annual rate of 4 percent early in 2017 to just 1.2 percent early in 2018, weighed down by a slippage in the Bloomberg index of consumer sentiment as the housing market turned down and employment growth cooled.

## Ontario and BC lead job losses in Canada's labour market

Income growth has been hamstrung by job losses since December. In the first five months of the year, Canada has shed 50,000 jobs. The job loss was concentrated in Ontario and British Columbia. Ontario's employment fell 0.3 percent in the first quarter, after the minimum wage hike of nearly 25 percent took effect on January 1, and there was virtually no recovery in April and May. The slowdown in BC dates back to last June, coincident with the election of a New Democratic Party government. Between June 2017 and May 2018, employment in BC fell 0.5 percent as the government has adopted a number of measures that have depressed business confidence. This loss of jobs is in sharp contrast to the buoyancy in BC's labour market in the previous two years, with gains of 3.1 percent between June 2015 and June 2016 accelerating to an impressive 4.6 percent gain between June 2016 and June 2017. While Vancouver's buoyant housing market continues to sustain growth in the construction industry, there have been marked slowdowns in the resource and service sectors in BC.

# About the Author



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