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Commentary

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Investment, Exports Suffering in Business-Unfriendly Canada

Economy remains heavily dependent on surging debt, while government policies discourage more dependable sources of growth

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Overview

Economic growth in Canada, while starting off strong in 2017, faced significant challenges arising from a decline of housing demand and continued weakness in exports and business investment. Governments and households have failed to move away from achieving spending growth through debt funding to more sustainable economic foundations. Growth in the third- and fourth-quarter declined as a result. Prospects for an economic turnaround in 2018 are not ideal, given the lukewarm response to Budget 2018, growing concerns over the federal deficit, and the continuing decline of business investment (especially when compared to the more buoyant investment climate in the United States). Upcoming provincial elections in Quebec and Ontario, which might bring in more business-friendly governments, have resulted in a reluctance for businesses to invest in either province. Abetting this trend is the growing concerns over the future of free trade in North America.

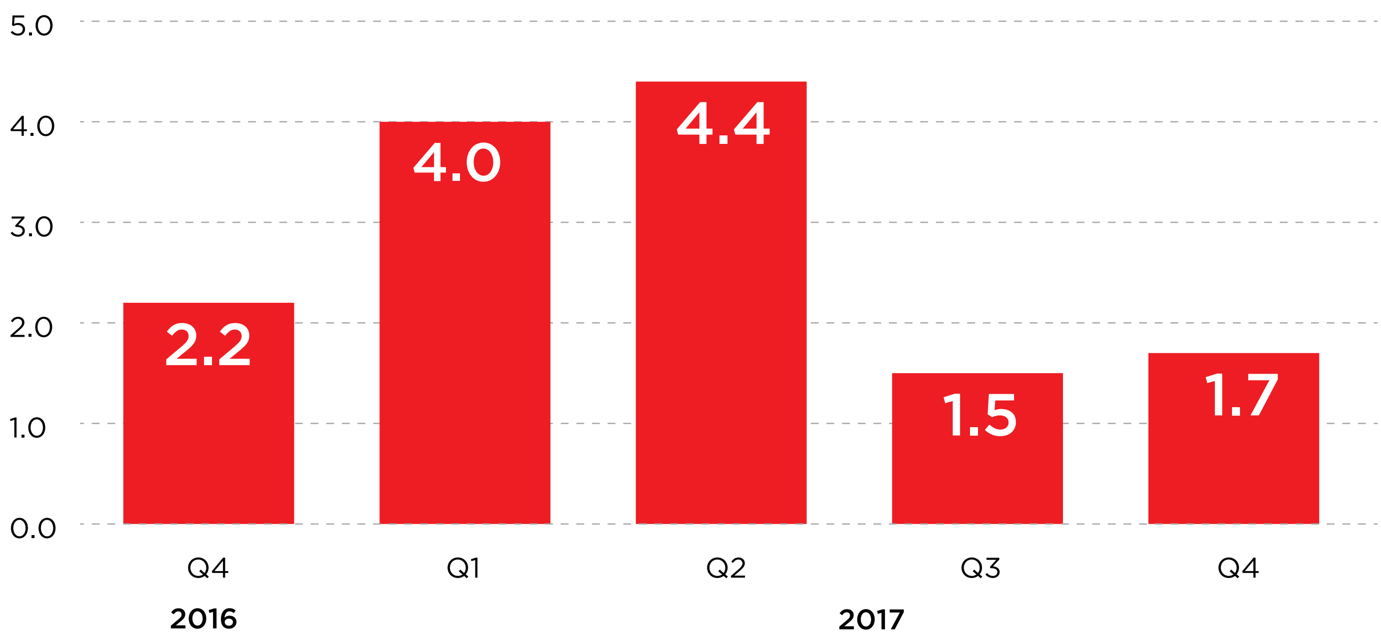
Introduction

After a buoyant start to 2017, the Canadian economy's growth slowed significantly in the second half of the year. The slowdown reflected continued lethargy in exports and business investment and a cooling of the torrid housing market, especially in Toronto. While employment fell sharply in January 2018, this does not appear to reflect a further deceleration of growth since the Macdonald-Laurier Institute composite leading index rose 0.4

percent that month – a sign of sustained if moderate growth. However, the failure to make the transition away from household and government spending means the economy is still overly-reliant on debt for growth.

In retrospect, the underlying trend of the economy was never as strong as its annual rate of growth of just over 4 percent made it seem (Chart 1). Some of the growth in the first half of the year was clearly borrowed from the second half, notably the building up of inventories in the auto industry in anticipation of extended shutdowns for retooling. Some of the growth in the first half also represented a recovery in the oil and gas industry after two years of extensive cutbacks. Even within the oil industry, however, some of the gains were unsustainable, reflecting the completion of large oilsands projects started years ago before oil prices crashed. Now that these projects have been completed, investment by the oil industry is projected to hit new lows in 2018, as is discussed in more detail later in this report.

CHART 1: Quarterly Real GDP Growth (at annual rates)



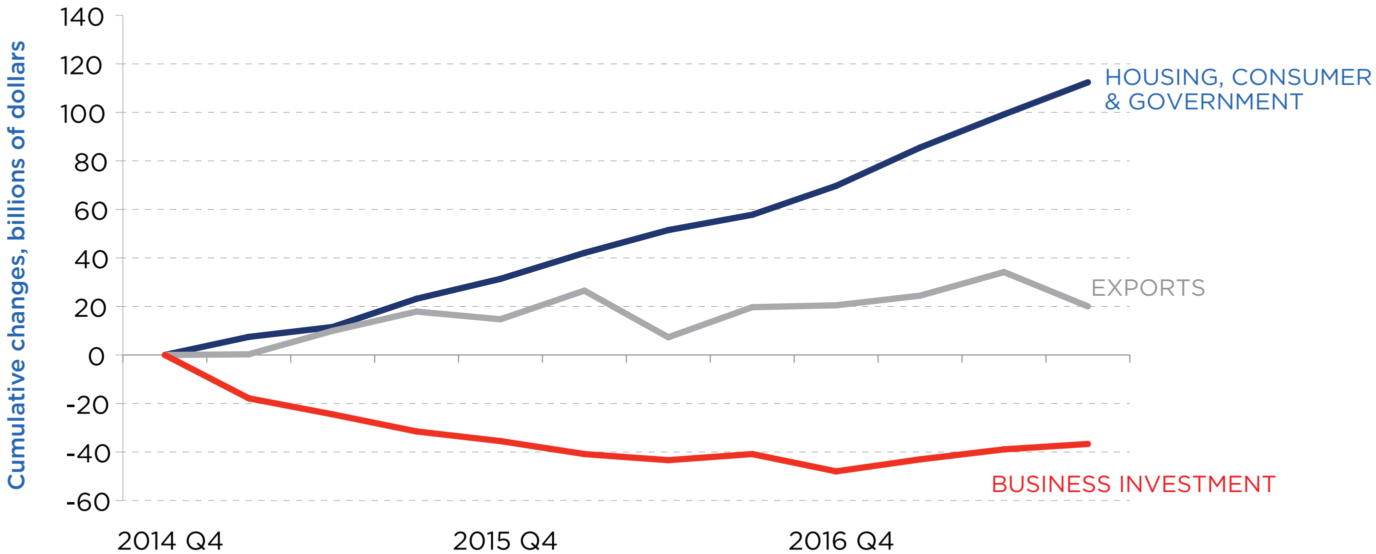
Source: Statistics Canada CANSIM Table 380-0084

Weak exports and business investment continue to hamper growth

The Bank of Canada has for years encouraged the transition of Canada's economic growth from household and government spending to exports and business investment via a lower exchange rate. Spending growth still largely dependent on debt funding would be vulnerable to higher interest rates, especially as the Bank begins to normalize interest rates. Exports and business investment are more sustainable sources of growth, with the added bonus that more investment would raise Canada's long-term potential.

However, the reality is that the economy has failed to shift from household and government spending to exports and business investment. Chart 2 shows the cumulative first difference in the volume of spending by these three sectors of the economy (the graph aggregates government and household spending into one category) since the oil price shock began at the end of 2014. It displays the first difference rather than the percentage growth of spending in these sectors to underscore that the combined household and government sectors are nearly three times larger than exports and ten times greater than business investment. The implication is that for exports and business investment to replace all the dollars generated by household and government spending, they would have to grow much faster than the latter.

CHART 2: Final Demand - 2007 constant prices, expenditure-based (dollars)



Source: Statistics Canada CANSIM Table 380-0084

Instead of rising faster, the growth of exports and business investment has not even kept pace with household and government spending, never mind replace it dollar for dollar. Since the end of 2014, household and government spending combined have rise by nearly $120 billion. Over the same time period, exports have increased by only $20 billion, while business investment fell by $40 billion. In terms of growth rates, household and government spending rose by 8.6 percent, more than double the 3.9 percent gain in exports while business investment fell by 15.7 percent.

So the Canadian economy remains heavily-dependent on debt-fuelled increases in household and government spending for growth. In fact, its dependence on these sectors has increased over the past year, with their combined growth accelerating from 3.5 percent in the first six quarters after the oil price shock to 4.9 percent in the last six quarters. Meanwhile, export volumes have fallen slightly since early in 2015 while business investment has levelled off at 20 percent below its 2014 peak.

The continued dependence on household and government spending to sustain growth is one reason the Bank of Canada is reluctant to follow the US Federal Reserve Board in raising interest rates. Higher interest rates not only would hinder domestic spending but also would put upward pressure on the exchange rate even as exports are struggling to grow at all. More generally, the continued reliance on household and government spending poses a conundrum for policymakers. Much of the growth of household and government spending is being fuelled by debt – one reason Canada's overall debt to GDP ratio is now the highest in the advanced economies (Cross 2017). This inhibits the Bank of Canada from raising interest rates, which would curtail growth by forcing households and governments to spend more on servicing their debt. However, the longer the Bank of Canada waits to increase interest rates, the more households and governments will continue to go into debt, increasing the risks to growth over the longer-term. These conundrums would disappear if exports and business investment picked up, since growth in these sectors is not as reliant on debt financing.

For the moment, the federal government is relying on tighter regulation of lending and not higher interest rates to rein in mortgage borrowing, apparently with some initial success as home sales retreated in January. But it remains to be seen if a slowdown in housing demand and prices will be sustained and whether less mortgage borrowing will translate into a broader slowdown in total household demand for credit and less government borrowing. Curbing government borrowing seems particularly problematic, given the federal budget tabled in February called for net borrowing to rise from $23.5 billion in fiscal 2017-18 to $34.8 billion in 2018-19 and stay above $30 billion for the next four years (Department of Finance 2017, 326).

Exports should have benefited from the 20 percent devaluation of the exchange rate since the 2014 oil price crash. Instead, however, exports have stagnated despite a strengthening global economy. While exports of resource-based products (notably energy) recovered, exports of manufactured goods slumped when they are usually the main beneficiaries of a lower dollar. Business investment should have benefited from higher profits earned from exports as the dollar devalued as well as the passing of the worst of the cuts in the oilpatch.

The continued lethargy in exports and business investment appears related to disenchantment with a wide range of government policies perceived as anti-business. These include sharply higher minimum wages in Ontario and Alberta, a nation-wide carbon tax, the continued obstruction of new pipeline construction, and new regulations for labour in Ontario and for the federal government's environmental review process. The continuing indifference of governments in Canada to the cumulative impact of these policies on business sentiment stands in stark contrast with developments in the US, where tax reform lowered corporate taxes enough to erase Canada's long-standing advantage, compounded by accelerated write-offs of US capital spending and a declining regulatory burden.

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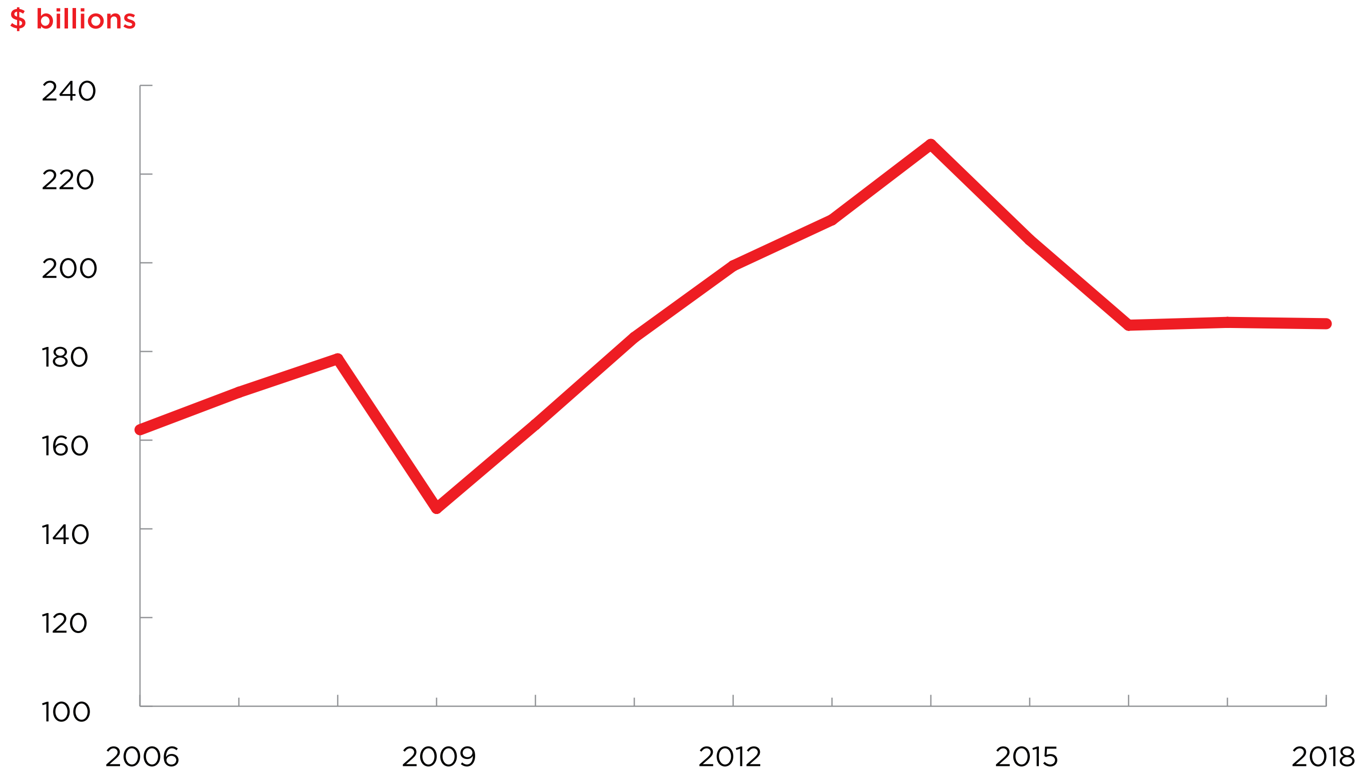
Business reduces investment plans for 2018

Nominal business investment is poised for a 0.2 percent decline in 2018, according to Statistics Canada's annual survey of the investment intentions of 25,000 companies (Chart 3).[1] These data do not take account of higher prices; assuming prices continue to rise by about the one percent rate posted on average in recent years, the volume of business investment would fall about 1.2 percent. This would erase the small gain posted in 2017, leaving investment about 20 percent below its 2014 peak.

CHART 3: Non-Residential Business Investment



Source: Statistics Canada CANSIM Table 029-0045

Investment continues to fall most rapidly in the oil and gas industry. Partly this reflects the completion of several oilsands projects in 2017. With no new projects starting up, oilsands investment plans fall to $10.2 billion in 2018, the lowest on record back to 2006 and far below their peak of $35.7 billion in 2014. While oilsands projects are planned over very long time horizons, spending on conventional oil and gas is more sensitive to current conditions. It is revealing that investment by the conventional oil and gas industry falls from $24.7 billion in 2017 to $23.0 billion in 2018, despite the firming of the price of West Texas Intermediate oil in recent months which sparked higher drilling in the US.

The steady drop for conventional oil and gas investment here reflects two factors working against drilling in Canada. First, the discount for Western Canadian Select oil has risen sharply in recent months, as the increased shipment of bitumen from the long-planned oilsands projects coming on line is trapped in the US market because of the lack of pipeline capacity to overseas markets. As well, drilling in Alberta continues to fall as regulations and a carbon tax make it less attractive to explore and develop oil and gas.

Business investment was little changed in most other industries. Transportation ekes out a small gain for 2018, as a raft of urban transit projects in Ontario and Quebec offset a drop in pipeline construction from $8.3 billion to $7.4 billion. Despite widespread reports that 'brick and mortar' retailing is dying, investment in retail stores edges up slightly as increases for food, drug stores and gasoline stations outweighed a sharp drop for department stores. Investment in finance (mostly banks) remains near historical lows at about $4 billion, compared to nearly $20 billion a decade ago. There is no obvious explanation for such an extreme drop; less construction of new branches does not seem to be a factor, as construction outlays rose over this period. Even utilities plan little change in investment after a large increase last year, as sharply higher spending in Ontario was offset by cutbacks in Quebec.

Manufacturers overall plan to invest $16.0 billion in 2018, up slightly from the year before but still well below their outlays of $16.5 billion in 2016 and $18.7 billion in 2015. Most of the increase in manufacturing was in petroleum refineries and chemical plants in Alberta. Investment in factories in central Canada remains little changed, despite the stimulus of a low dollar and high capacity utilization. Manufacturers are especially reluctant to commit to constructing new facilities; construction has fallen every year from $6.2 billion in 2014 to just $3.4 billion in 2018.

Instead firms are only willing to invest more in machinery and equipment, which does not require the same commitment to remaining in Canada as construction (machinery and equipment in a factory can always be moved across the border much more easily than a factory). This reflects the reluctance of firms to commit to investments in Ontario and Quebec amid the uncertainty surrounding free trade talks with the US and provincial elections in both provinces this year that may pave the way for governments more receptive to the business communities.

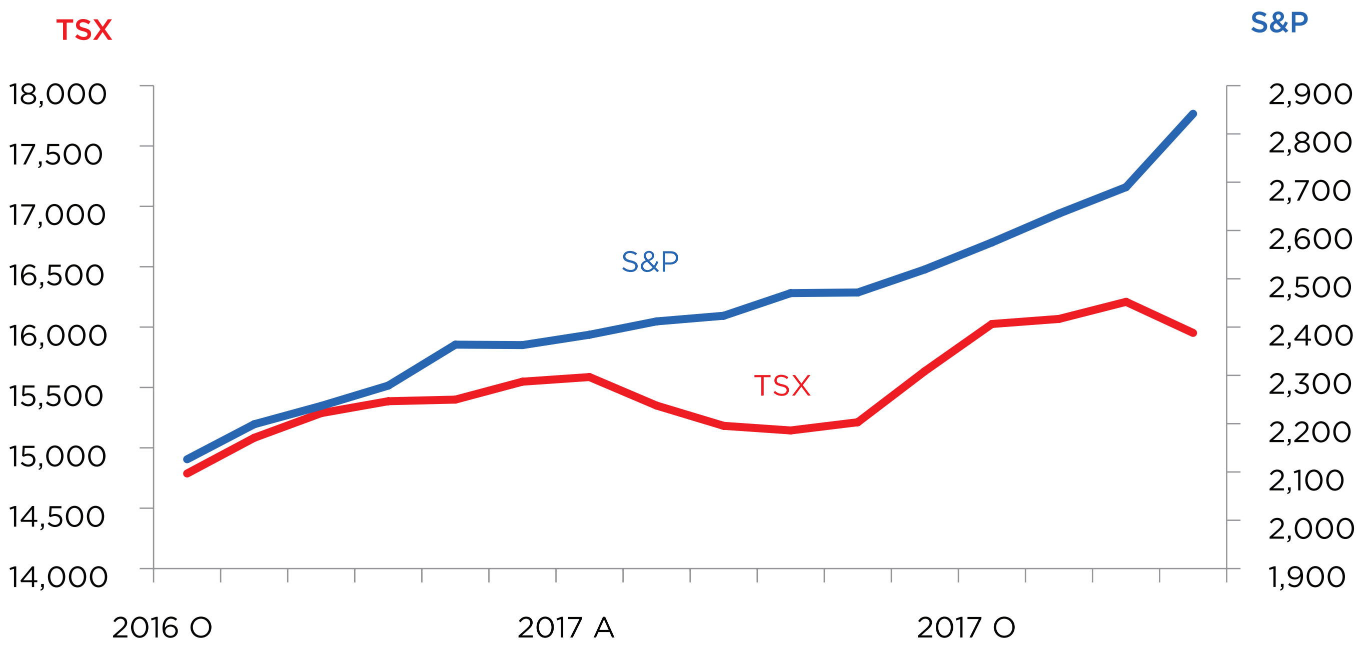
> "The slump in Statistics Canada's survey of business investment is in marked contrast with the optimism the Bank of Canada reported in its own survey of investment."

The slump in Statistics Canada's survey of business investment is in marked contrast with the optimism the Bank of Canada reported in its own survey of investment. In its latest survey, the Bank found "broad-based positive investment intentions" that would push investment "back to near post-recession highs" (Bank of Canada 2018). This is much different than Statcan's portrayal of business investment continuing to flounder about 20 percent below its 2014 high.

Since both surveys were taken late in 2017 (when the passage of corporate tax cuts in the US was still uncertain), the difference seems obviously related to the sample of firms covered. The Bank of Canada surveys 100 companies, while Statcan covers 25,000. In particular, the Bank's small sample cannot cover many industries and especially smaller firms, which were most affected by the federal government's proposal last summer to tax retained earnings (subsequently withdrawn) and the Ontario government's sudden hike in the minimum wage to $14 an hour on January 1. As a result of these and other measures, the Canadian Federation of Independent Business found the confidence among its small business members was below its average between 2010 and 2014 (Mallett 2018). By comparison, confidence among small business owners in the United States is near record highs at a time when tax rates are being slashed and the regulatory burden reduced (Dunkelberg and Wade 2018).[2]

The dispirited state of business confidence in Canada contrasts markedly with the revival of spirits in the American business community. Since the election of Donald Trump as President, the US stock market (measured by the S&P 500) has risen by 34 percent. Over the same period, prices on the Toronto stock market have increased by 7.8 percent (Chart 4). Some of the divergence reflects the greater importance of technology stocks such as Facebook, Microsoft, and Alphabet in the US market and how these companies continue to dominate the global technology industry. However, Canadian stocks have lagged even in areas where it is dominant, such as energy companies whose value has suffered as the discount for Canadian oil in the US continues to increase. A recent report by Scotiabank calculated that the discount for Western Canadian crude is costing the economy $15 billion this year.

CHART 4: Stock markets, Canada and US



Source: Statistics Canada CANSIM Table 176-0046

The continuing slump in business investment is important for a number of reasons. Obviously, it depresses current spending in the economy and limits job growth. In the longer-term, it reduces potential growth and long-term productivity gains. Most importantly in the current economic environment, persistent weakness in investment limits the Bank of Canada's ability to wean the economy from its addiction to debt-fuelled growth in household and government demand by shifting to exports and business investment.

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.

2 The small business optimism index stood at 106.9 in January 2018, just below its all-time record high of 108.0 reached in July 1983.

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