A Macdonald-Laurier Institute Publication

True North in Canadian public policy

Commentary

December 2016

Manufacturing Sector Defies Policy-Makers' Hopes for Growth

Falling exchange rate hasn't boosted exports, while growing debt, declining savings and sluggish growth reveal the negative consequences of government stimulus

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HIGHLIGHTS

The story of the Canadian economy for the last quarter is one of reduced savings, growing government debt, and a manufacturing sector that has defied policy-makers' hopes for growth.

We have seen the national saving rate decline from over 10 percent before the financial crisis, to 6.6 percent in 2014, and below 2 percent so far in 2016. Corporations posted a deficit of $19.7 billion this past quarter, after a $26.7 billion shortfall in the previous quarter. The image of firms sitting on piles of so-called "dead money," as coined by former Bank of Canada Governor Mark Carney in 2012, if it was ever true, clearly has been discredited after the rout in oil prices erased profits in the oilpatch.

Governments ran a total deficit of $37.6 billion, nearly $10 billion more than the previous quarter. However, none of the increase reflects the promised "stimulative" higher spending on infrastructure, as government spending on fixed investment rose by only 0.8 percent in the past four quarters, a marked slowdown from year-over-year growth of nearly 5 percent in the summer of 2015.

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Despite the rebound in energy exports in the third quarter, the total volume of exports remains 0.3 percent below their level in the third quarter of 2015. In particular, exports of manufactured goods have not responded to the lower value of the Canadian dollar as the Bank of Canada had expected. Some analysts have been quick to blame the loss of competitiveness on the rising exchange rate before the recession (the so-called "Dutch Disease"). But it has become clear that the loss in capacity over that period was not great.

The Bank of Canada has begun to change its tune. It now cites a wide range of policies that affect the attractiveness of investing and producing in Canada (some specific to Ontario) that a 25 percent drop in the exchange rate has not overcome. These include "energy cost differentials, rising non-tariff barriers, uncertainty about the status of current and future trade agreements, and slow and complex project approval processes."

The fundamental problem, as outlined in my recent paper for the Macdonald-Laurier Institute, is that eight years of stimulative monetary and fiscal policies have reduced their effectiveness to the point that they are harming the underlying productive potential of the economy.

"Consumers did not further increase their spending growth despite the billions they received from the federal government's Canada Child Benefit."

OVERVIEW

The Canadian economy rebounded in the third quarter from the wildfires in Northern Alberta that lowered output in the second. Real GDP increased 0.9 percent, led by a 6.1 percent recovery in energy exports as oil sands output came back on line. However, employment growth over the last two quarters remained unchanged at 0.2 percent, and job growth stayed sluggish in October and November. Together with the continuing slow and steady growth signalled by the 0.3 percent gain in the Macdonald-Laurier Institute's Leading Economic Indicator in October (MLI 2016), this strongly suggests that the buoyancy in third-quarter growth was due to one-time factors and does not represent the long-awaited breakout to annual growth of more than 3 percent that analysts and Canadians have been hoping for since 2010.

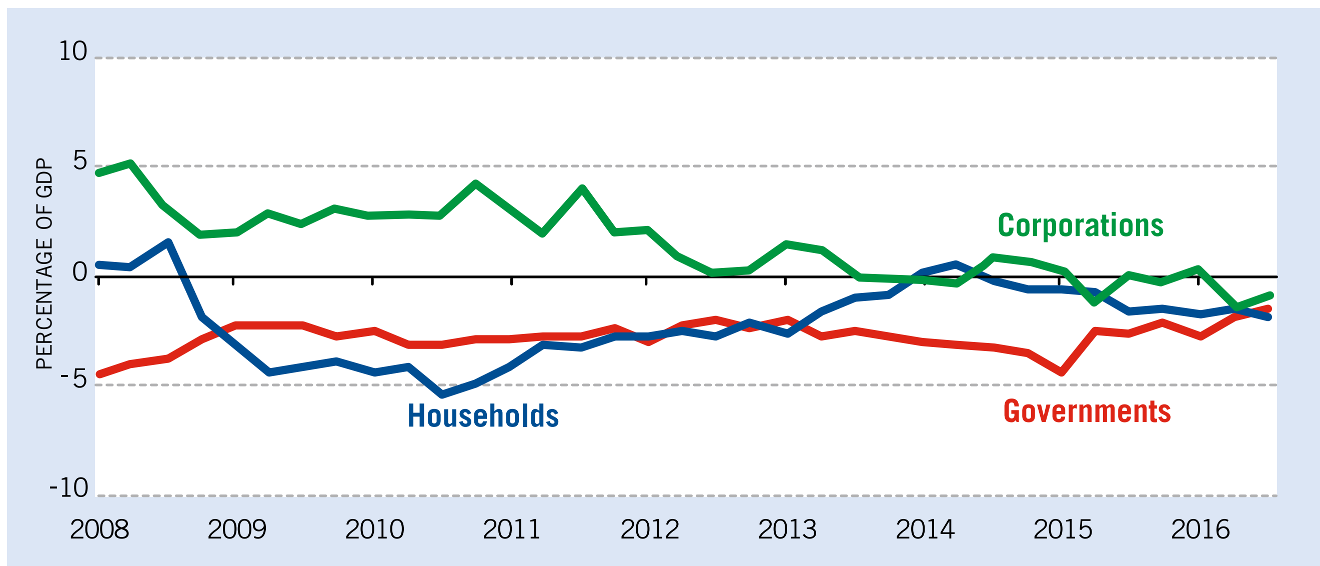
The rotation of growth away from household demand to manufactured goods exports and business investment remains on hold. Household demand did show signs of slowing in the third quarter; consumers did not further increase their spending growth despite the billions they received from the federal government's Canada Child Benefit, while housing fell outright for the first time since the winter of 2014. However, export volumes and business investment both remain below their levels of a year earlier. While energy exports rebounded from their decline following the wildfires in Northern Alberta, manufacturing exports continue to falter.

The most striking change in the economy recently has not been in the sources of growth but in the pattern of borrowing and saving. All sectors of the economy are now net borrowers (ultimately financed by non-residents), with governments and corporations joining households in spending more than they earn. Not surprisingly, this shift to more indebtedness has accompanied a steady decline in the national saving rate, from over 10 percent before the financial crisis, to 6.6 percent in 2014, and below 2 percent so far in 2016.

MORE BORROWING AND LESS SAVING FAIL TO BOOST GROWTH

All sectors of the Canadian economy continue to run deficits. Net borrowing by households moderated to $30.5 billion (at annual rates) in the third quarter, after reaching over $60 billion in 2015. This reduction reflects increased transfers from the federal government, which households chose to save rather than spend, and a cooling of demand for housing. Corporations posted a deficit of $19.7 billion, after a $26.7 billion shortfall in the previous quarter. The image of firms sitting on piles of so-called "dead money," as coined by former Bank of Canada Governor Mark Carney, if it was ever true, clearly has been discredited after the rout in oil prices erased profits in the oilpatch.[1] Finally, governments ran a total deficit of $37.6 billion, nearly $10 billion more than the previous quarter (figure 1).

Figure 1: Net lending by sector



Source: CANSIM Tables 380-0071 and 380-0064.

Figure 2: National saving rate

Source: CANSIM Table 380-0071

With all sectors of the economy borrowing to sustain their spending, it is not surprising that the national saving rate has turned sharply lower. After hovering between 6 and 7 percent through most of 2014, the national saving rate has averaged 1.9 percent so far this year (figure 2). (Saving is the difference between

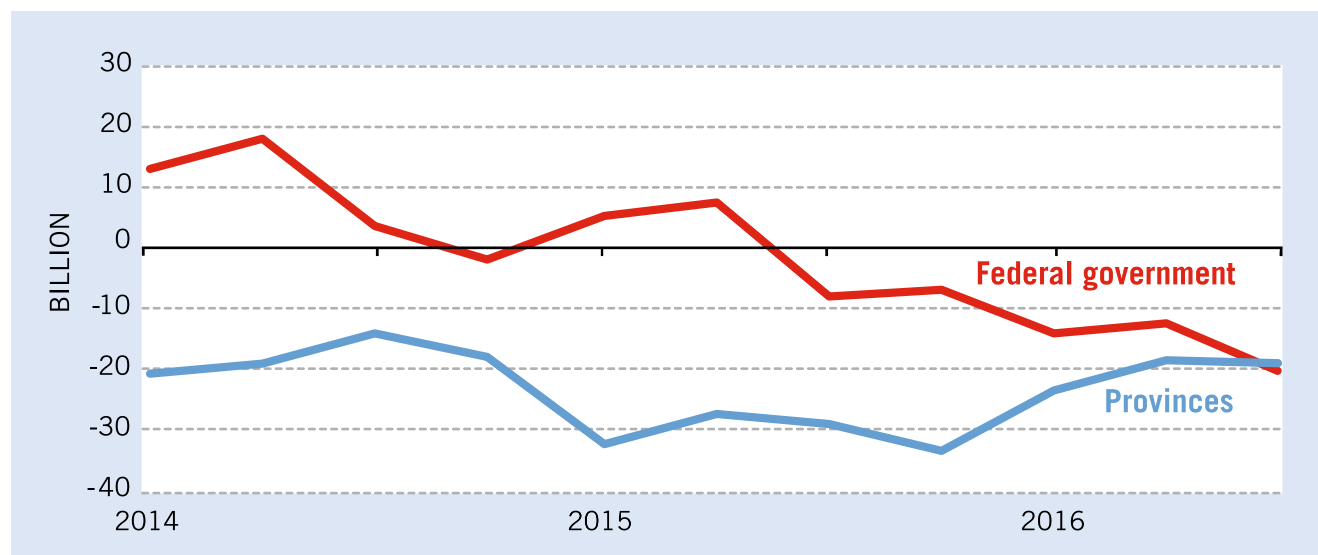
current spending and income; net borrowing adds in debt incurred for capital investments such as housing, roads, and plant and equipment.)

Governments continue to increase their fiscal stimulus. Total net borrowing by governments reached a total of $37.6 billion (at annual rates) in the third quarter; in the summer of 2015 it was less than $15 billion. The federal government accounts for most of this this increased borrowing; it flipped from small surpluses in the first half of 2015 to a deficit of $20.5 billion in the third quarter of 2016. However, none of the increase reflects higher spending on infrastructure, as government spending on fixed investment rose by only 0.8 percent in the past four quarters, a marked slowdown from year-over-year growth of nearly 5 percent in the summer of 2015.

> "All of the increase in household disposable income went into saving (up $10 billion) or to meet higher consumer prices."

The federal deficit was pushed higher in the third quarter by payments to households, up $5.3 billion, mostly for the Canada Child Benefit. All of the increase in household disposable income went into saving (up $10 billion) or to meet higher consumer prices. As well, higher federal transfers to the provinces of $3.0 billion over the past year raised the trend of the federal deficit while helping the provinces reduce their net borrowing from around $30 billion last year to $20 billion so far this year (figure 3). This is partly why federal transfers to the provinces have not translated into more infrastructure investment.

Figure 3: General goverment net borrowing



Source: CANSIM Table 380-0079

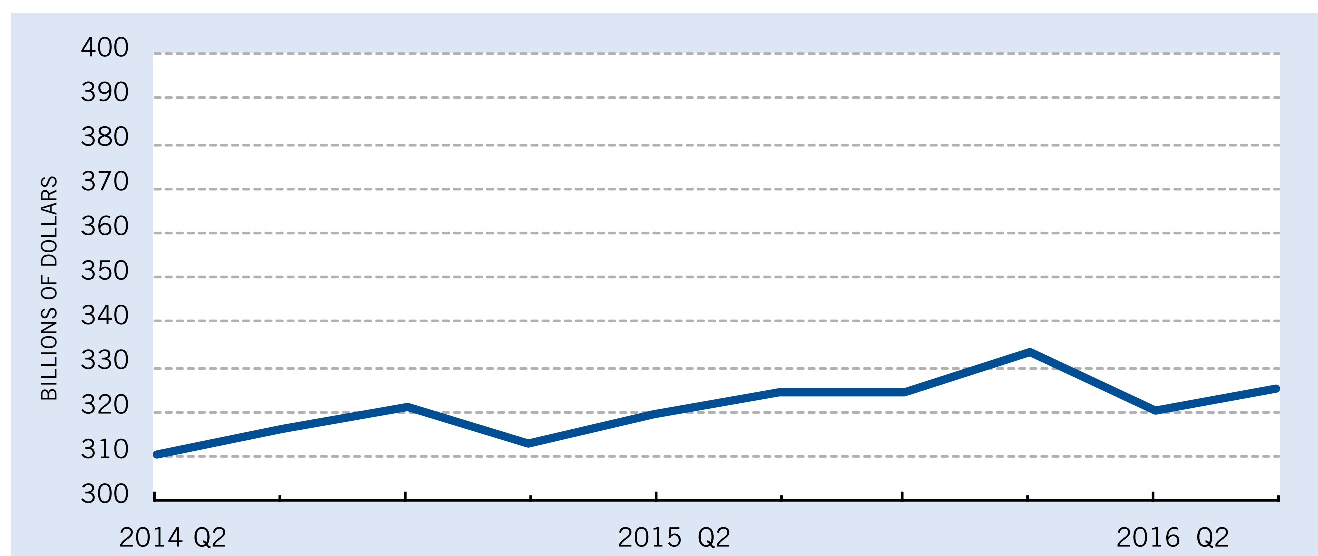
MANUFACTURING EXPORTS CONTINUE TO FALTER

Despite the rebound in energy exports in the third quarter, the total volume of exports remains 0.3 percent below their level in the third quarter of 2015. In particular, exports of manufactured goods have not responded to the lower value of the Canadian dollar as the Bank of Canada had expected. Manufacturing remains the weakest sector in MLI's Leading Economic Indicator, with new orders down and the average number of hours worked in a week remaining flat.

The Bank of Canada had expected a quick transition in export growth from the energy sector to non-energy sectors. In October 2014, the Bank identified "evidence of more sustained growth" in exports of fabricated materials, machinery and equipment, and building and packaging materials. However, all three sectors soon stalled or began to retreat. For machinery and equipment, export volumes (excluding aircraft) peaked almost as soon as the Bank made its forecast of sustained growth; they have fallen 3.8 percent since the first quarter of 2015 (or down 0.5 percent excluding aircraft). Exports of fabricated materials peaked in the third quarter of 2015 and then declined 2.2 percent through the third quarter of 2016. Building materials reached their high in the first quarter of 2016 and then dipped 2.4 percent. The fact that exports from these sectors have retreated from their highs shows that capacity constraints were not the main factor; for whatever reason, firms either lost their export market or shifted production to facilities outside of Canada.

Overall, the volume of exports of all manufacturing goods[2] has essentially stagnated between the third quarter of 2015 and the third quarter of 2016, after edging up 2.6 percent in the previous four quarters (figure 4). The Bank of Canada was consistently over-optimistic about the ease with which manufacturing capacity could be rebuilt, assuming that increased capacity use alone would trigger more investment in Canada while ignoring the possibility that firms would add capacity in other countries, even with a lower Canadian dollar.

Figure 4: Exports of manufacturing goods, in constant dollars



Source: CANSIM Table 380-0070

The Bank of Canada has repeatedly changed its narrative about the puzzling weakness of manufacturing exports. Initially in 2015 it attributed the weakness to a loss of capacity after factories closed due to a loss of competitiveness and then the recession.[3] Some analysts have been quick to blame the loss of competitiveness on the rising exchange rate before the recession (the so-called "Dutch Disease"). However, nothing in the Bank's statements rules out other factors hindering competitiveness, such as sharply rising electricity rates and proliferating regulations in Ontario. It is not even clear how much capacity was destroyed over the past decade. New data from Statistics Canada reveal a steady downward trend in business exits since 2001, over and above the relatively insignificant 5.3 percent rise in businesses closing down during the recession in 2008 (although clearly there were instances of factory closings, notably in the textile, clothing, and forestry-related industries over the past decade) (Statstics Canada, CANSIM Table 527-0001). What is remarkable in the data on business formation and exits is the dearth of new firms being born.

As the expected recovery of manufactured exports failed to materialize in 2016, the Bank of Canada broadened its understanding of the factors holding back exports. In January 2016, it noted that while the Canadian dol-

lar had depreciated, “the currencies of other competing commodity-producing economies, such as Australia, Mexico, Chile and Brazil, have also depreciated relative to the U.S. dollar” (Bank of Canada 2016a, 22). By October, it admitted that this factor “appears to be more important than previously assessed” (Bank of Canada 2016b, 14).

In October 2016 the Bank of Canada broadened its analysis to include other factors in order to explain the slack in manufactured goods exports. To understand weak exports, the Bank of Canada now cites a wide range of policies that affect the attractiveness of investing and producing in Canada (some specific to Ontario) that a 25 percent drop in the exchange rate has not overcome. These include “energy cost differentials, rising non-tariff barriers, uncertainty about the status of current and future trade agreements, and slow and complex project approval processes” (Bank of Canada 2016b, 15). The latter does not refer to pipelines (although their approval process is certainly slow and complex), which do not have an impact on manufactured exports, but includes transportation infrastructure such as roads and bridges.

The Bank noted that firms have been meeting increases in export demand through their foreign facilities rather than exports from Canada and that, “in this context, persistent productivity underperformance and stronger relative wage gains in Canada have been working to gradually erode the competitiveness of Canadian exports, despite the depreciation of the Canadian dollar in recent years” (Bank of Canada 2016b, 15). In fact, the October 2016 report made no reference to a loss of capacity as a factor restraining exports. (Governor Poloz did refer to a loss of $30 billion of export capacity in a speech in November 2016, although this represents only 4.8 percent of total exports and just 1.5 percent of GDP (Poloz 2016).[4])

The slack in manufacturing exports extended to autos over the last two quarters. Until recently, autos had been an exception to the under-performance of manufacturing exports, partly reflecting the re-opening of plants after extensive retooling in the first half of 2015. However, while both auto sales and production continue to advance in the US, production and exports from Canada have faltered since the summer. The volume of Canadian auto exports fell 3.4 percent from its high in the first quarter of 2016. Meanwhile, exports of a wide range of other manufactured goods have declined since the turn of the year, including consumer goods, machinery and equipment, and industrial goods.

CONCLUSION

The frustration of policy-makers with their inability to reignite faster growth is palpable. It was evident in Mark Carney’s mistaken and futile appeal for firms to spend the “dead money” they were allegedly hoarding, although it now appears that it would have been wise for firms to have saved some money for the inevitable cyclical slump in earnings. Now the Bank of Canada is puzzled by the failure of exports of manufactured goods to respond to the stimulus of a lower exchange rate. Meanwhile, government deficits have risen over the past year, but not because of the much-touted burst in government investment spending, which has actually slowed, partly as the provinces siphon off federal transfers to repair their tattered balance sheets. Through it all, overall economic growth remains sluggish and job growth anaemic.

The fundamental problem, as outlined in my November 2016 paper for the Macdonald-Laurier Institute, *The Limits of Economic Stimulus,* is that eight years of stimulative monetary and fiscal policies have reduced their effectiveness to the point that they are harming the underlying productive potential of the economy. These policies have increased the distortions to saving, investing, and borrowing behaviour, heightening the risks in the global financial system, while reducing the fiscal capacity of governments to deal with the fallout from another financial crisis and an aging population. History shows that every recession or crisis in North America since at least 1970 had its origins in the distortions introduced by policy-makers to fix the previous downturn. However, these distortions pale by comparison with the changes induced by eight years of ultra-low interest rates and rising government debt. In such an environment, it should hardly be surprising that firms and households do not respond as expected to policies designed to stimulate short-term growth.

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ENDNOTES

1 What also is clear is that jawboning from the governor of the Bank of Canada has no impact on the calculus of business spending decisions. In fact, legendary bond fund manager Bill Gross argues that firms are not investing because of the easy money environment created by central banks; they know that the short-term stimulus from low interest rates will be at the expense of future spending.

2 Manufactured goods exports include metal and non-metallic products; basic and industrial chemicals, plastics and rubber; forestry products and building and packaging materials; industrial machinery; electronic products, motor vehicle products, aircraft; and consumer goods.

3 In the Bank's words "A prolonged period of deteriorating competitiveness, punctuated by the Great Recession, led to the destruction of many firms and depressed business investment outside the energy sector, resulting in significantly reduced capacity in the non-resource sector." It went on to add that "Permanent reductions in capacity, including through firm exit, result in the loss of some capacity for future production" (Bank of Canada 2015, 20-21).

4 The $30 billion was first mentioned in the October 2014 report as an estimate of the difference between what the Bank expected exports to be based on its Foreign Activity Measure and actual exports; as such, it is not a precise measure of lost capacity since it also reflects the shortcomings of the Foreign Activity Measure as a proxy of exports.

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