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Commentary

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Forces Behind Slow Growth Won't Respond to Stimulus

Tepid economy will continue to be slowed by sluggish manufacturing sector and decline in business investment, which won't be solved by deficit spending by government

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HIGHLIGHTS

While Canada's economy was off to a strong start in 2016, it wasn't to last. And the MLI Leading Economic Indicator signals continued slow growth. This tepid outlook is rooted in two important factors: the failure of manufacturing to respond to the stimulus of low oil prices and the devaluation of the Canadian dollar, and a second straight year of falling business investment.

It is important to understand then that this is not a shortfall of demand. That is, the Keynesian justification of deficit spending in the recent federal budget to stimulate the economy is misdirected. The problem is one of resource allocation. Shifting resources from the energy industry to other sectors is a process that will take up to 2019, according to the Bank of Canada. Deficit spending can do little to alter that outcome. Indeed, policies that deter business investment, such as failing to balance budgets, will slow down this adjustment process.

The Leading Indicator reveals that the sources of output growth felt at the beginning of the year were ephemeral and would not be sustained in the first half of 2016. Much of the upturn reflected the passing of temporary factors that depressed output last year, notably the closing of auto factories for extensive retooling and energy production disruptions in the oil sands. Already, monthly GDP dipped in February and March.

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While quarterly output growth fluctuated widely over the past year, employment growth was very stable at 0.2 percent in each of the last four quarters. This picture of slow, steady growth is probably a better reflection of the underlying trend of the economy. This is borne out by the most recent MLI Leading Indicator, which showed a 0.1 percent gain in April, after several 0.1 percent declines to start the year.

The devastating wildfires in northern Alberta that led to the evacuation of Fort McMurray and the suspension of output at several oil sands plants will depress output in the second quarter, although much of this loss will be offset by spending on the 2016 Census (the last census added nearly $600 million to real GDP in the second quarter of 2011). The resumption of oil production and the rebuilding of parts of Fort McMurray will lend some strength to output in the second half of the year.

A significant issue is that manufacturing activity has been very slow to respond to lower oil prices, the devaluation of the Canadian dollar, and steady growth in the United States, all factors that historically have boosted manufacturing in Canada. Instead, manufacturing output was essentially unchanged (+0.1 percent) between the fourth quarter of 2014 and the first quarter of 2016.

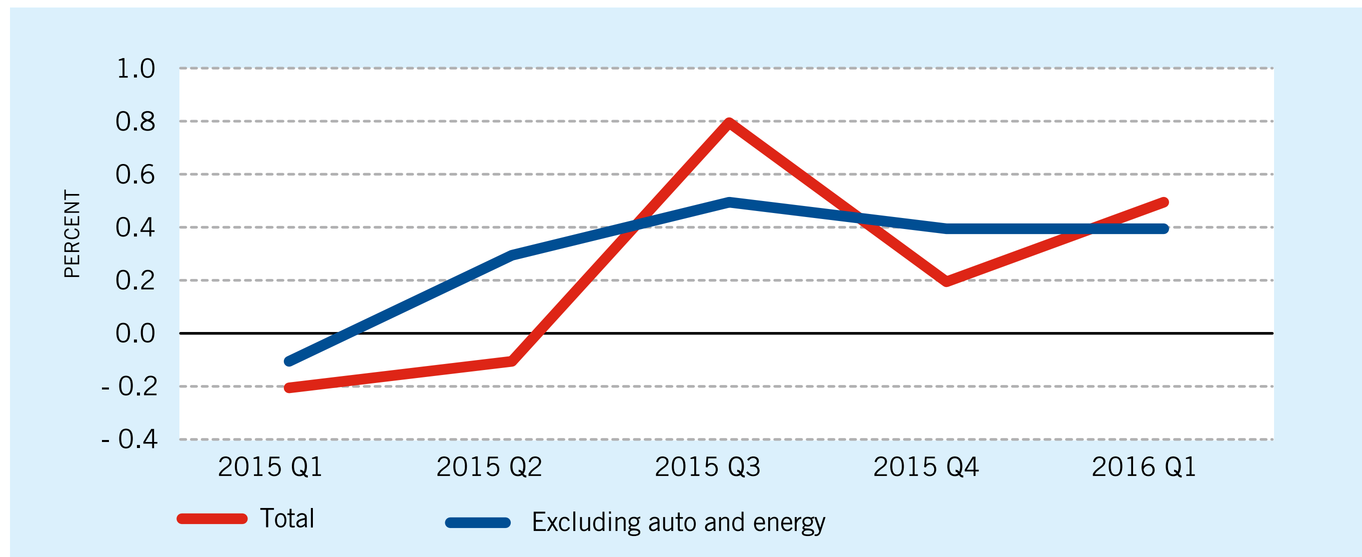
Quarterly business investment fell 3.7 percent, its sixth consecutive decline. In its annual survey of business investment plans, Statistics Canada found that firms in the business sector plan to cut capital spending another 6.5 percent in 2016, on the heels of a 10.5 percent drop in 2015.

OVERVIEW

The Canadian economy surpassed expectations in the first quarter of 2016, with real GDP expanding 0.6 percent after a 0.1 percent increase in the previous quarter. This acceleration of growth followed a slowdown through most of 2015. Much of the upturn reflected the passing of temporary factors that depressed output last year, notably the closing of auto factories for extensive retooling, and energy production disruptions due to fires and maintenance in oil sands plants.

While quarterly output growth fluctuated widely over the past year, employment growth was very stable at 0.2 percent in each of the last four quarters. This picture of slow, steady growth is probably a better reflection of the underlying trend of the economy. The stability of employment is matched by constant dollar[1] GDP excluding autos and energy, which grew by about 0.4 percent in each of the last four quarters even as the growth of total GDP swung between a quarterly drop of 0.1 percent and an increase of 0.8 percent (see chart 1).

Chart 1: Quarterly GDP growth



Source: STATCAN Table

The MLI Leading Indicator signals continued slow growth in the Canadian economy. This tepid outlook is rooted in two important forces holding back growth: the failure of manufacturing to respond to the stimulus of low oil prices and the devaluation of the Canadian dollar, and a second straight year of falling business investment. Weakness in these two sectors points to supply constraints playing a more important role in limiting growth prospects, rather than just a shortfall of demand.

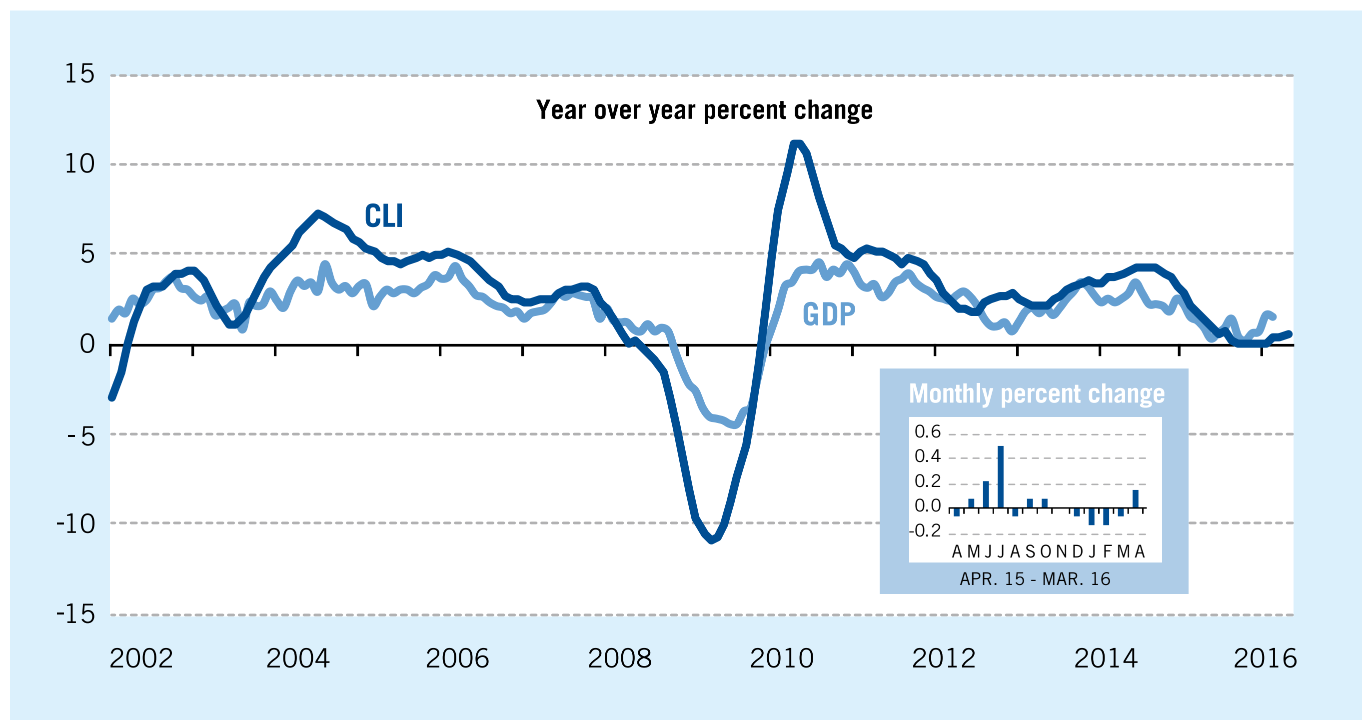
MLI'S LEADING ECONOMIC INDICATOR

The MLI Leading Economic Indicator is a composite index designed to signal an upcoming turn in the business cycle, either from growth to recession or from recession to recovery, six months in advance, with an error rate of less than 5 percent. It does so by monitoring what businesses and households have actually committed to in terms of future spending and production in the most cyclically-sensitive sectors of the economy. It also incorporates global influences such as the direction of the US economy and the broad thrust of monetary policy.

MLI LEADING INDICATOR POINTS TO SLOWER GROWTH

This impression of steady if pedestrian growth in the trend of the economy was borne out by the Macdonald-Laurier Institute Leading Economic Indicator (see chart 2).

Chart 2: MLI Leading Economic Indicator



The most recent reading was a 0.1 percent gain in April, after several 0.1 percent declines to start the year.[2] The tepid performance of the leading index, even as GDP accelerated early in the new year, is symptomatic of the fact that the sources of output growth were ephemeral and would not be sustained in the first half of 2016. Already, monthly GDP dipped in February and March.

The devastating wildfires in northern Alberta that led to the evacuation of Fort McMurray and the suspension of output at several oil sands plants will depress output in the second quarter, although much of this loss will be offset by spending on the 2016 Census (the last Census added nearly $600 million to real GDP in the second quarter of 2011). The resumption of oil production and the rebuilding of parts of Fort McMurray will lend some strength to output in the second half of the year.

Beyond the gyrations of quarterly growth, two important trends augur continued slow growth in the underlying trend of the economy over the remainder of 2016. The first is lacklustre manufacturing activity, and the second is the continuing slump in business investment. The weakness in these sectors points to important supply constraints on economic growth, not a shortfall of demand that the Keynesian deficit-financed spending we saw in the last federal budget is meant to address.[3] These supply constraints are rooted in a lack of investment in productive capacity and the failure to connect plants in eastern Canada to the cheap oil being produced in western Canada, which instead is being exported to the benefit of users in the midwestern US.

MANUFACTURING REMAINS LACKLUSTRE

Manufacturing activity has been very slow to respond to lower oil prices, the devaluation of the Canadian dollar, and steady growth in the US, all factors that historically have boosted manufacturing in Canada. Instead, manufacturing output was essentially unchanged (+0.1 percent) between the fourth quarter of 2014 and the first quarter of 2016.

The stall in manufacturing over the last five quarters reflects a stand-off between steep losses in capital goods industries that have had to cope with slumping business investment and modest gains for autos and resource-based manufacturers. Output of capital goods has fallen nearly $4 billion, led by declines of over $3 billion for producers of fabricated metals and machinery, both of which supply much of the equipment used by the oil and gas and mining industries (output of agricultural, construction, and mining machinery equipment alone plunged by $1.7 billion). Aerospace also declined in response to the long-standing troubles at Bombardier.

Meanwhile, output of motor vehicles and parts has edged up only 4 percent since late 2014, despite record sales in the US. Auto output fell sharply in the first half of 2015 due to extensive retooling. These gains were recovered in the second half of the year as production at these retooled plants gradually returned to full capacity (capacity use overall in the auto industry was 97.8 percent at the end of 2015),[4] although with more value-added.

Resource-based manufacturers have posted only small gains since late 2014, despite the stimulus of lower costs for their energy inputs. Forestry-based plants such as lumber and paper have led the way, with gains of about 10 percent. However, these industries are approaching their productive limits, with capacity utilization rates of 99.3 percent in wood and 98.2 percent in paper in the fourth quarter of 2015. Like autos, they will be unable to grow, despite healthy export demand.

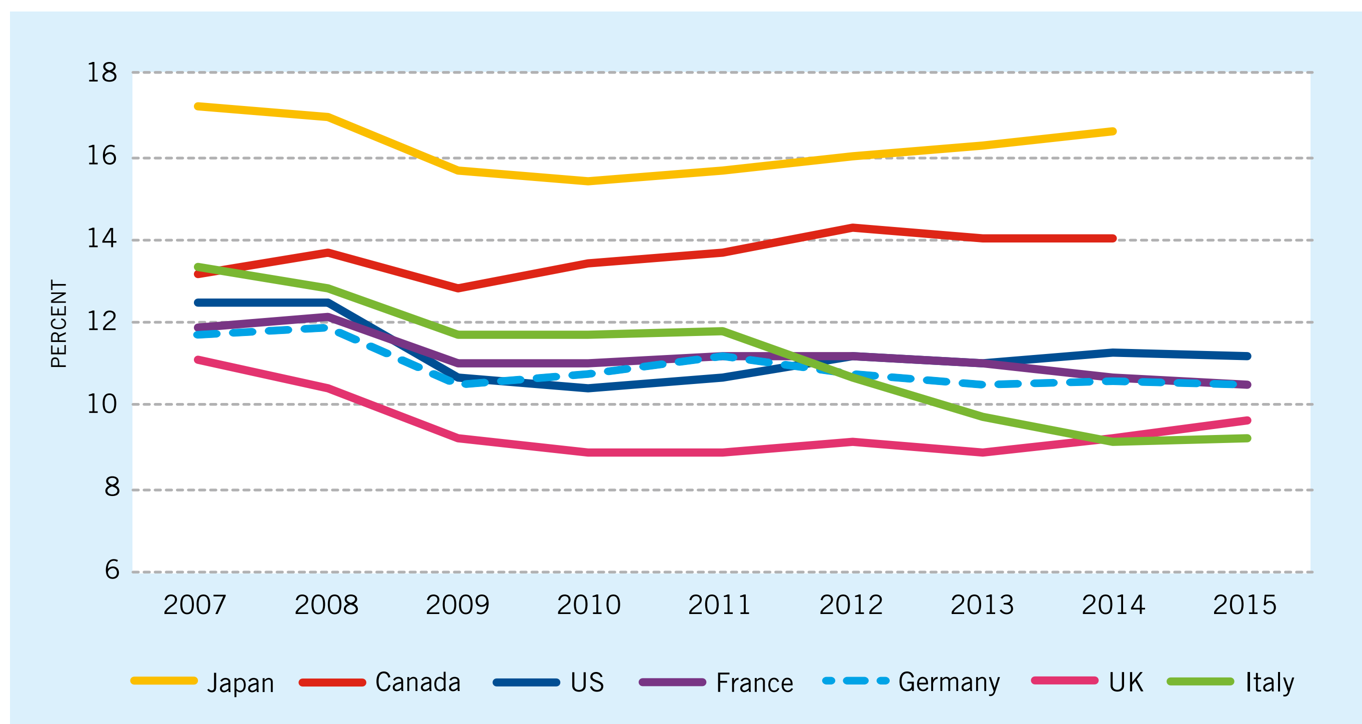
Petroleum and chemical industries posted only small gains, partly because refiners in eastern Canada face competition from plants that can access cheaper oil sources in western Canada. Food manufacturers posted their usual slow, steady gains, while primary metals have stagnated, with gains in smelting and refining offset by losses for iron and steel as their markets in capital goods dried-up.

BUSINESS INVESTMENT CONTINUES TO SLUMP

Even more fundamental to the outlook for economic growth in Canada is the continued weakness in business investment.[5] Quarterly business investment fell 3.7 percent, its sixth consecutive decline. In its annual survey of business investment plans, Statistics Canada found that firms in the business sector plan to

cut capital spending another 6.5 percent in 2016, on the heels of a 10.5 percent drop in 2015. The drop in 2015 and 2016 means that business investment in Canada no longer retains its exceptional status in the G7. Between 2007 and 2014, Canada was the only G7 country where the share of business investment in GDP fully recovered from the recession (chart 3). Lagging business investment has been a feature throughout the major industrial nations, and a major reason why economic growth has been so weak and why estimates of potential growth have been downgraded.

Chart 3: Business investment share of GDP



Source: OECD.stats

The drop in investment of course was led by the oil and gas industry, which is slashing investment in response to the steep drop in prices over the last two years. Of more concern is renewed weakness in manufacturing investment, despite high rates of capacity utilization and profitability. Most of the weakness in manufacturing investment originated in Ontario. Autos led the retrenchment, after last year's extensive retooling. Retooling at auto plants led to a sharp drop in auto output in the first half of 2015. Output recovered over the second half, and reached a new high of $19 billion in the first quarter.

However, no further investments are planned in the auto industry, which is now running at close to full capacity, implying it will not be contributing more to growth in the forseeable future (in fact, one assembly plant is scheduled to close next year, while the future of two parts plants is in doubt). The drop in manufacturing investment in Ontario contrasts with widespread gains in manufacturing investment next door in Quebec, despite weakness in the aerospace industry due to the troubles at Bombardier.

ENERGY PULLS DOWN EXPORTS

The renewed weakness of oil prices at the turn of the year was reflected in sharply lower oil exports, which plumbed their lowest quarterly level since 2002. However, commodity prices began to firm in the spring,

giving a lift to the Toronto stock market. These two components helped to buttress the leading indicator in April, which eked out a 0.1 percent gain after a string of 0.1 percent declines to start the year.

Canada's external current account trade deficit expanded from $15.7 billion in the fourth quarter to $16.8 billion in the first quarter. All of the change originated in lower energy exports, which fell $3.4 billion. As a result, the share of energy in total exports slid from 27 percent two years ago to 11 percent, their lowest since 2002 as prices have plummetted 62 percent since the first quarter of 2014. Meanwhile, the share of autos in total exports rose from 13 percent to 20 percent over the past two years, their highest in over a decade. Non-residents financed Canada's trade deficit by buying $30.3 billion of our bonds and $10.3 billion of stocks.

Sustaining growth in Canada's non-energy exports will be difficult in 2016. Growth in the US continues to be anaemic, with real GDP up only 0.2 percent in the first quarter. The 0.1 percent increase in the leading indicator for the US augurs continued slow growth, although the US Federal Reserve Board has signalled that this is sufficient to justify another increase in interest rates over the summer, barring shocks to the global economy.

Meanwhile, a couple of factors that favoured growth in Canada's manufacturing exports ended in the first quarter. The three-year tailspin in the Canadian exchange rate – during which it matched the 30 percent devaluation that took nearly three decades between 1976 and 2002 – came to an end, with the loonie rising nearly 10 cents. At the same time, the retooling of the auto sector is now complete.

MILD WEATHER BOOSTS HOUSING

Household spending contributed to growth in the first quarter. Housing led the gain, helped by unusually warm winter weather in western Canada. However, the housing index in the leading indicator turned down 0.1 percent in April as the short-term boost weather lent to housing starts passed. Consumer confidence remains the major source of weakness in the leading index, falling to its lowest level since early 2012. Turbulence in financial markets and rising unemployment in western Canada weighed on consumer spirits.

CONCLUSION

Quarterly variations in Canada's GDP were pronounced in 2015, and will continue to be volatile in 2016. As a result, it is more difficult than usual to determine the underlying trend of economic activity. The new Macdonald-Laurier Instiute Leading Indicator is designed to highlight what the true trend of the economy is. It signals slow growth, as the economy continues to be hampered by falling business investment and lacklustre manufacturing activity.

ABOUT THE AUTHOR

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ENDNOTES

1 Constant dollar GDP is used from Statistics Canada Cansim Table 379, because these estimates are additive while the Chain Fisher estimates are not.

2 Detailed information on the leading indicator and its component data is available only on the Bloomberg Terminal.

3 Another supply side constraint on growth over the longer-term is the aging of the population, but this is not a reason for growth in 2016 to be slow compared with adjacent years.

4 All the data on capacity utilization in this report are from Statistics Canada Cansim Table 028-0002.

5 *Business investment* is defined as total investment excluding public administration, education, and health care. The data come from Statistics Canada Cansim Table 029.

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