

ECONOMIC VIEWPOINT

Business Investment Will Have to Pick Up in Quebec and Ontario

A few months ago, Statistics Canada's survey on the 2019 investment outlook suggested it would be a very good year. The wind seems to have shifted quickly, with global uncertainty intensifying. Will businesses in Quebec and Ontario still go ahead with all their projects? Along with weaker SME confidence and business earnings, the labour shortage is another factor putting the brakes on investment. Despite all the obstacles, investments are imperative in order to boost productivity. Time is of the essence for Quebec, which is substantially behind internationally. Ontario must also continue its efforts to avoid losing more ground.

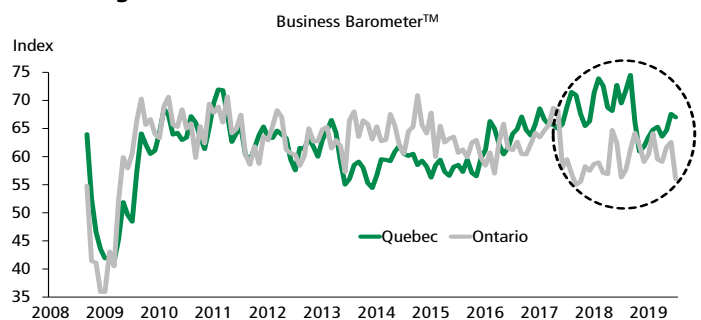
Expectations vs. Reality

A few months ago, Statistics Canada released the results of its survey of investment intentions for this year. At that point, Quebec and Ontario were ahead of Canada's other provinces. Although it looked promising, 2019 might not live up to expectations. The deterioration in the economic situation elsewhere in the world is having repercussions here.

The trade tensions between the United States and many other countries have resulted in numerous tariffs and shaken business confidence. Canada was not spared, with tariffs on steel and aluminum applied in May 2018. Relations with the United States took a turn for the better thanks to the removal of the tariffs in May 2019, and willingness to ratify the new Canada–United States–Mexico trade agreement (CUSMA) shortly. However, Canada's relations with China have deteriorated, with meat exports suspended entirely since the end of June.

All the rebounding, combined with the global economy's deterioration, is prolonging the uncertainty for business, and preventing a more convincing turnaround in SME confidence in Quebec and Ontario (graph 1). Confidence is not the leading factor in investment decisions, but it still plays an important role. According to the Bank of Canada (BoC), the erosion in business confidence has pushed back investment decisions in many countries, including Canada.¹ According to the Business Barometer™ published in July by the Canadian Federation of Independent Business (CFIB), two thirds of employers nevertheless believe their business is doing well in Quebec

GRAPH 1
Although relatively low, SME confidence is well above where it was during the 2008–2009 recession



Sources: Canadian Federation of Independent Business and Desjardins, Economic Studies

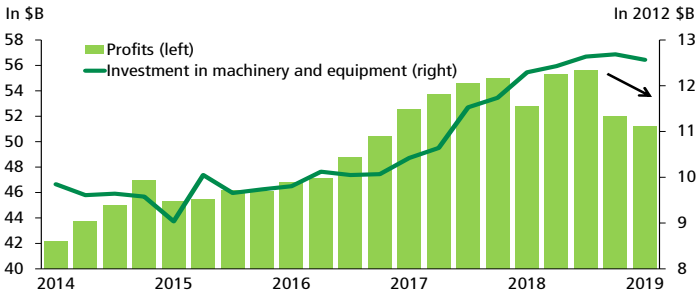
compared with 43% in Ontario. However, this is not enough to stimulate investment.

Profits Have Stopped Rising

Certain economic indicators, which are generally closely tied to changes in investment, are starting to flag. Firstly, net corporate after-tax income, which had shot up in 2017 in tandem with spending on machinery and equipment, started to trend down at the end of last year (graph 2 on page 2). Lower profits can reduce business leeway and shake confidence. Investment projects can then be shelved until the situation improves.

¹ Remarks by Carolyn A. Wilkins to the Calgary Chamber of Commerce, Bank of Canada, May 30, 2019, 10 p.

GRAPH 2
Quebec business profits have begun to decline

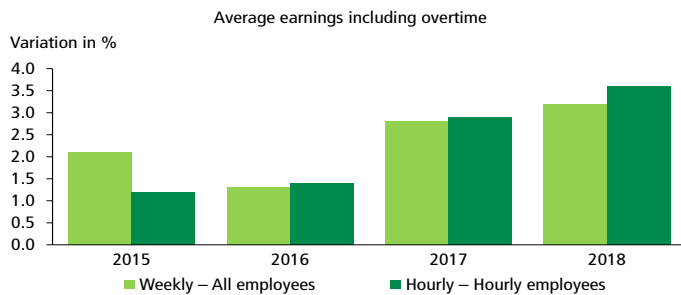


Sources: Institut de la statistique du Québec and Desjardins, Economic Studies

The Labour Shortage Is a Factor

The rise in business costs probably took a bite out of earnings.² The increasing scarcity of labour is putting upside pressure on wages. In 2018, employees’ average hourly earnings rose 3.6% in Quebec, faster than in previous years (graph 3). In Ontario, earnings also grew more than 3% last year. Payroll is usually a major component in business costs. Nearly 60% of Quebec and Ontario SMEs are concerned about payroll expenses. Where rising labour costs affect businesses’ financial health, they can also jeopardize investment plans.

GRAPH 3
Businesses have to absorb the faster wage growth in Quebec



Sources: Statistics Canada and Desjardins, Economic Studies

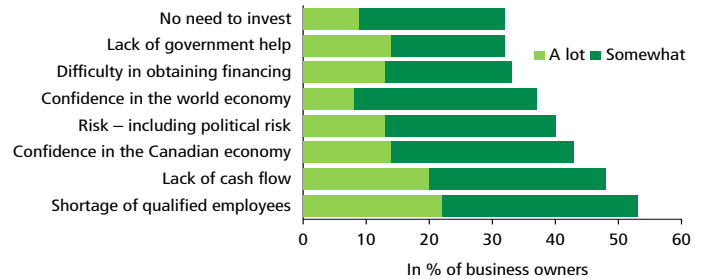
The Dearth of Employees Puts the Brakes on Investment

In addition to the acceleration in wages, a struggle to recruit workers in order to maintain or expand production is keeping some businesses from investing. According to a survey³ conducted by the Business Development Bank of Canada (BDC), a shortage of qualified employees is the principal obstacle to SME investment, followed by a lack of liquidity (graph 4). The

² *Upward Pressure on Business Costs in Quebec*, Desjardins, Economic Studies, *Economic Viewpoint*, November 29, 2018, 4 p.

³ *Investment Intentions of Canadian Entrepreneurs: An Outlook for 2019*, Business Development Bank of Canada, January 2019, 19 p.

GRAPH 4
Factors that will limit investment by Canadian SMEs in 2019, according to a BDC survey



BDC: Business Development Bank of Canada
Sources: BDC and Desjardins, Economic Studies

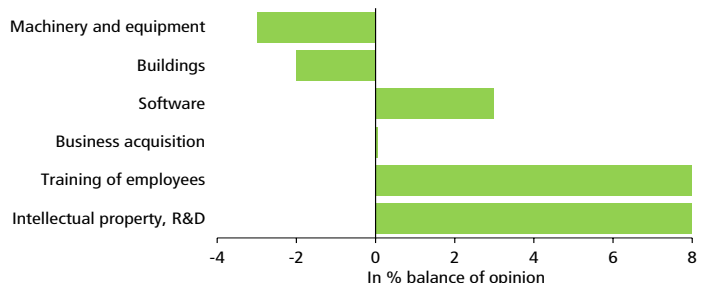
level of confidence in the Canadian and international economies, and the various risk factors, are also part of the equation at investment time. Problems getting financing or a lack of government assistance are less important decision factors. One worrisome fact is that many businesses do not think that investing is essential, even though investment helps make them more competitive, fosters SME growth, and generates more earnings, according to the BDC.

Numerous Types of Investment

Businesses can spend capital in several ways. In the past, physical investments were preferred, such as investments in construction or enlarging buildings, or spending on machinery and equipment. This type of investment is easier to quantify for businesses, and for various government surveys, but it does not take all the technological advances into account. Most industries have gone digital, which calls for other types of spending. In addition to installing new computerized systems and using new software, employee training and research and development account for a growing share of business investment plans.

According to BDC’s survey for 2019 (graph 5), the results speak for themselves. Also according to the BDC, 43% of the country’s businesses will spend to adopt new technologies this year. The

GRAPH 5
Types of investment forecast for Canadian businesses in 2019, according to a BDC survey



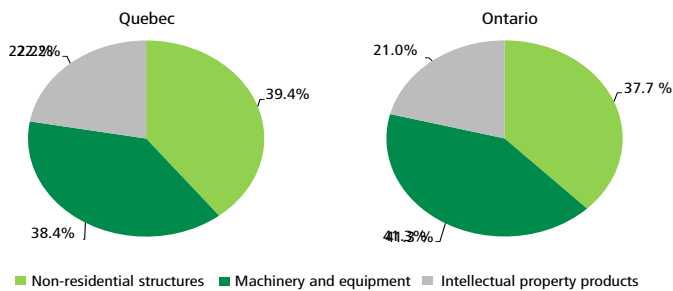
R&D: Research and development; BDC: Business Development Bank of Canada
Sources: BDC and Desjardins, Economic Studies

decision to invest in areas other than physical (tangible) assets reflects a change in behaviour for business. Moreover, there are more players in advanced sectors than there were before, which changes how investing is done.

Intellectual Property Investments

A complete picture requires a consideration of non-physical expenditures (intangible assets). Beyond the surveys that provide a snapshot of intentions, the technological aspect is harder to capture in numbers. A few years ago, official bodies like Statistics Canada and the Institut de la statistique du Québec introduced the concept into their measurement of economic activity. Spending on intellectual property products accounts for approximately 20% of total business investment in Quebec and Ontario (graph 6). This category covers such things as expenses incurred to develop new technologies, new products and new manufacturing processes. It often involves research and development, which creates intangible value for the company. This type of investment usually increases productivity and makes firms more competitive in domestic and international markets.

GRAPH 6
Breakdown of 2018 business investment



Sources: Institut de la statistique du Québec, Ontario Ministry of Finance and Desjardins, Economic Studies

In general, a greater concentration of high-tech industries in an economy means intellectual property investment will be higher. Here, the United States has a solid lead over Canada. This type of spending has increased of more than 20%, in real terms, since 2015 there. The high density of tech businesses in the United States and, therefore, a more intense R&D effort explains the boom.

Canada has a much lower concentration of advanced sectors. Despite that, investment in intellectual property products is disappointing. Canada stood still in this area between 2015 and 2018. Real growth in intellectual property investment was tepid in Quebec and Ontario, at about 6% and 1.7% respectively over three years, according to the economic accounts metric.

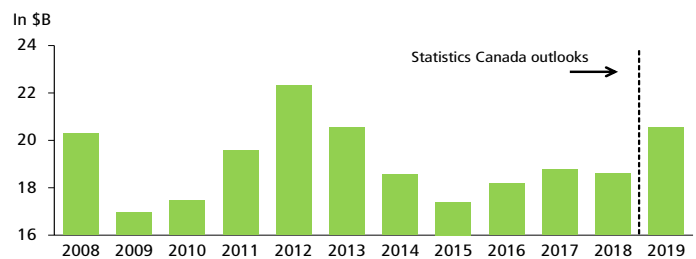
These results cast doubt on the two provinces' ability to increase productivity quickly through this type of spending, so effort in the area of intellectual property investment will have to

intensify. According to the BDC survey, plans to move ahead with non-physical spending are high in Canada for 2019, but they will have to come to fruition.

Record of Private Sector Investment

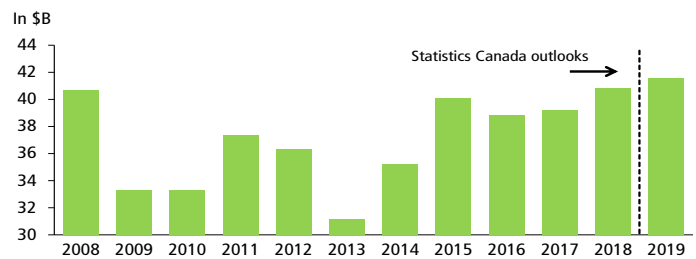
In Quebec, private sector investment has edged up somewhat since 2016, but not enough to make up for the substantial lag in previous years (graph 7). On the other hand, Ontario has recouped all of the ground lost in the last ten years, without going further (graph 8).

GRAPH 7
Investment* by private sector businesses in Quebec



* Non-residential construction and machinery and equipment. Sources: Statistics Canada and Desjardins, Economic Studies

GRAPH 8
Investment* by private sector businesses in Ontario

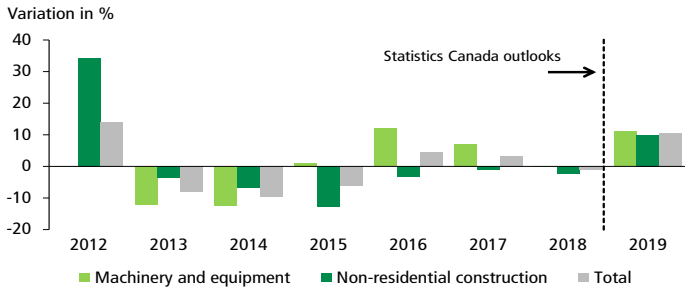


* Non-residential construction and machinery and equipment. Sources: Statistics Canada and Desjardins, Economic Studies

Business spending on non-residential construction, machinery and equipment is assessed each year by a thorough Statistics Canada survey. The detailed picture for Quebec and Ontario shows that private sector investment has been lacklustre in the last several years (graphs 9 and 10 on page 4). Yet both economies experienced excellent economic growth, as the North American economy's expansion cycle persisted.

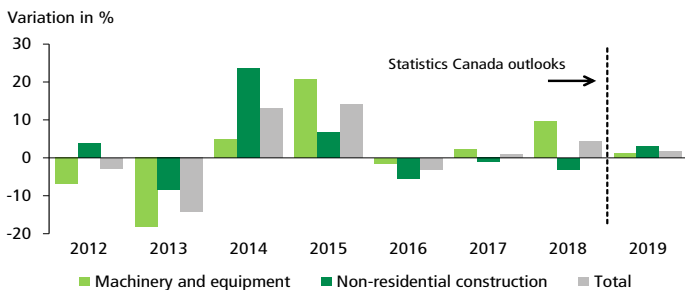
The struggles in Ontario's auto sector and closure of several assembly plants over the years helped sap the province's total investment, however. Quebec's manufacturing sector has contrasted negatively in the last few years in terms of the

GRAPH 9
Investment by private sector businesses in Quebec



Sources: Statistics Canada and Desjardins, Economic Studies

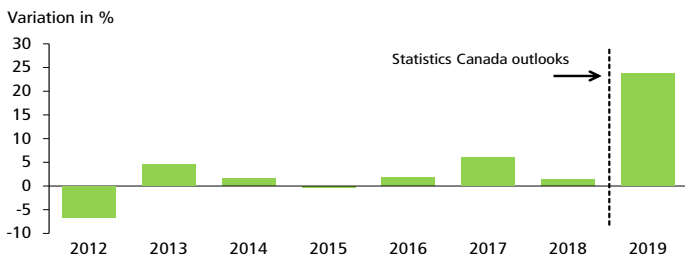
GRAPH 10
Investment by private sector businesses in Ontario



Sources: Statistics Canada and Desjardins, Economic Studies

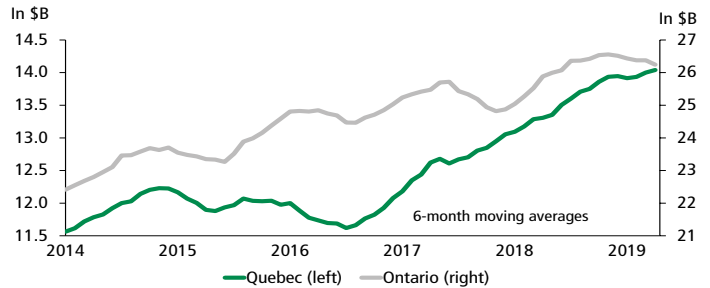
amounts invested in machinery and equipment (graph 11), even though manufacturing shipments went through a period of strong growth, much faster growth than in Ontario (graph 12). It seems that manufacturing investment did not follow suit. This is worrisome, because modernizing production equipment is critical in dealing with international competition. For the last several years, Statistics Canada's survey of manufacturing investment intentions has suggested strong future growth that is not

GRAPH 11
Prolonged, weak investment in machinery and equipment by Quebec manufacturers



Sources: Statistics Canada and Desjardins, Economic Studies

GRAPH 12
Manufacturing sales saw an excellent period



Sources: Statistics Canada and Desjardins, Economic Studies

materializing. The survey's outlook for 2019 for manufacturers could also be disappointing. The situation is different in the other sectors (table 1). Some of Quebec's main industries have shown good growth in recent years, while others are lagging. Transportation and warehousing, and mining, oil and gas have been posting strong growth for several years. On the other hand, the accommodation and food services industry is noteworthy for the retreat in investment. In Ontario, the string of ups and downs

TABLE 1
Investment* by private sector businesses in Quebec

MAIN SECTORS	2017	2018	2019 OUTLOOKS
Agriculture and forestry	+20.7%	-4.8%	+0.7%
Mining, oil and gas	+12.2%	+15.4%	+18.6%
Construction	+36.7%	-8.0%	+2.1%
Manufacturing	-0.7%	-1.3%	+26.0%
Wholesale trade	+0.3%	-1.6%	+17.8%
Retail trade	+10.5%	-1.8%	-8.8%
Transportation and warehousing	+16.4%	+29.7%	+18.6%
Real estate services	+14.7%	+2.2%	-2.7%
Accommodation and food services	-5.5%	-2.8%	+3.2%

* Non-residential construction and machinery and equipment.
Sources: Statistics Canada and Desjardins, Economic Studies

TABLE 2
Investment* by private sector businesses in Ontario

MAIN SECTORS	2017	2018	2019 OUTLOOKS
Agriculture and forestry	n/a	+10.0%	-8.1%
Mining, oil and gas	-6.6%	+11.4%	+2.9%
Construction	+11.2%	-8.1%	+2.1%
Manufacturing	+2.3%	+19.0%	-10.3%
Wholesale trade	+0.2%	+21.9%	-2.9%
Retail trade	+4.8%	-8.7%	-9.3%
Transportation and warehousing	+13.4%	-9.5%	+16.3%
Real estate services	n/a	+2.9%	+7.6%
Accommodation and food services	+7.6%	-14.2%	-7.8%

n/a: data not available; * Non-residential construction and machinery and equipment.
Sources: Statistics Canada and Desjardins, Economic Studies

in various sectors (table 2 on page 4) makes it hard to get a clear picture for some industries.

An Expansion Cycle That Is Short on Investment

The lengthy North American growth cycle and manufacturing boom of recent years have not been enough to trigger a wave of capital investment in Quebec's private sector. Businesses have begun to make the technological shift, but growth in intellectual property investment is sluggish.

Well aware of the urgent need for action, the federal, Quebec and Ontario governments have introduced tax incentives to encourage business investment. Let's hope this will be enough to make a difference in business investment decisions, as businesses will have to go the extra mile to stay in the race globally. The current expansion cycle could last a few more years, and investments must be made, despite the obstacles.

At a time when the context is slightly worse for entrepreneurs, the window of opportunity for investment spending seems to be closing. SME confidence has weakened in response to the problems in the global economy, and profits have begun to trend down. The labour shortage is also curbing investment, as well as increasing businesses' payroll costs. Ontario is facing similar issues as well. Despite these difficulties, investment intentions are up in most sectors and regions in Canada, according to the BoC's latest [Business Outlook Survey](#).

Hélène Bégin, Senior Economist