Economic Viewpoint

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ECONOMIC CONDITIONS ARE IMPROVING, BUT UNCERTAINTIES REMAIN

Canada’s economy barely pulled itself out of recession in the third quarter of 2009, with a 0.4% increase (annualized) in real GDP. The upturn in economic conditions then continued and recent shifts in economic indicators show that real production advanced by about 4.8% in the last quarter of 2009. The recession that hit Canada’s economy hard at the end of 2008 and in the first half of 2009 has, however, left its mark. It is likely that 2009 closed with a 2.5% pullback in real GDP. The outlook for 2010 is nevertheless rosier while improvements in economic conditions will push Canada’s real GDP to a 2.6% increase (graph 1). That said, there are lingering concerns about the strength of the economic recovery.

OUR CORPORATE COMPETITIVENESS MUST BE IMPROVED

One of the main obstacles to sustained and durable growth in Canada’s economy is the erosion of corporate competitiveness that has occurred these past few years. As we can see in graph 2, the unit labour cost in Canadian companies expressed in U.S. dollars has increased significantly in the past few years. The spread with the equivalent measure in American companies is becoming considerably wider. This reflects an important loss of competitiveness for Canadian companies as opposed to their counterparts south of the border.

This decline in competitiveness stems for a combination of two factors. First, the loonie’s appreciation is fuelling the

The competitiveness of Canadian companies has declined a great deal in the past few years. If this is not dealt with, it could prolong the difficulties in foreign trade, hinder the economic recovery and decrease Canadian’s standard of living. And yet businesses have consistently continued to invest in the past few years. In most cases, however, these investments served to increase production capacities instead of updating existing facilities. In terms of output, not only are Canada’s corporate balance sheets cause for concern, but this recession has dealt another blow to the industrial capacity utilization rate. That said, factors that favour investment and productivity gains are mounting, making room for some cautious optimism for coming years.

**NOTICE TO READERS:** The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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sustained increase in unit labour costs in Canada, expressed in U.S. dollars. The exchange rate has soared from a cyclical trough of US$0.62/C$ in January 2002 to close to its current level of US$0.94/C$ (reaching and then breaching parity at the end of 2007 and in early 2008). If not for the loonie’s ascent, the spread between the unit labour cost in Canadian and American companies would have been much tighter. Second, we have to admit that even if we exclude the effects of currency rate changes, cost increases have edged higher faster in Canada than in the United States. This discrepancy can be largely explained by Canada’s lower productivity gains.

For example, multifactor productivity\(^1\) declined by 5.2% in Canada between 2002 and 2008\(^2\) while companies in the United States saw their multifactor productivity surge by 9.3% during the same time frame. In Canada, labour productivity rose by 3.8% between 2002 and 2008, while capital productivity tumbled by 12.7%, wiping out any gains made by the labour component. This decline is largely attributable to the substantial investments made in the past few years to develop new production capacities. But it sometimes takes several years before these newfound production capacities are rolled out, which is why productivity is negatively impacted. This reality was quite widespread in the mining and oil and gas extraction industry where capital productivity has declined by 34.9% since 2002. That said, the many investments made in the natural resources sector will eventually bear fruit and see Canada benefit from its strong positioning to meet the needs of expanding global demand in the years to come.

The productivity record is less gloomy in some sectors, however (graph 3). The multifactor productivity in the manufacturing sector has fallen by only 0.5% since 2002, a less negative result than in most sectors of activity. That said, it is still wholly insufficient to tackle the loss of productivity stemming from a higher loonie, a particularly pressing problem in this sector.

**MORE INVESTMENT IS NEEDED**

To increase their productivity gains, companies will have to invest more and innovate more to get up to date. But the bulk of investments made in the past few years have been earmarked toward developing new production capacities, the end result being limited effects on productivity gains.

This increase in production capacities in the past few years, together with production declines during the last recession, led to a major drop in the industrial capacity utilization rate (graph 4 on page 3). At 67.5% in Q3 2009, not only was this rate at its lowest level since the inception of this time series, but the spread was 15.3 percentage points from its historical average.

If the drop in the utilization rate is fairly widespread, some sectors are more affected than others. The decline in the mining sector is particularly steep, with the utilization rate falling to just below the 50% mark. In other words, a little more than half of existing mining capacities were unused in the third quarter of 2009. Some industries in the manufacturing sector are also showing significant deterioration in their

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\(^1\) Multifactor productivity is the support of several factors to industrial output. This measure of productivity is a combination of (based on the relative importance of each output factor) work, capital (fixed capital and stocks) and intermediate inputs like innovation.

\(^2\) A major part of the decrease in productivity in Canada comes from mines, oil and gas sector.
utilization rate (graph 5). This is especially the case with the manufacturing of textiles, wood, rubber and plastic products, primary metals and transportation equipment. This last component, is deeply affected by the difficulties in the automobile and aerospace industries. For example, new automobile production plummeted to 75,683 units (seasonally adjusted data) in January 2009 during the bankruptcies in the United States, a level that is clearly less than the 246,208 units produced during the cyclical peak in December 1999. Even if production has jumped since the beginning of 2009, it is clear that Canada’s automobile industry is running far below its full capacity. And this situation could extend for a few more years while the Big Three manufacturers in North America implement their restructuring plan. The recent announcement that a Ford assembly plant will be completely shut down in 2011 will no doubt reduce the industry’s production capacity. However, the fact is, the trend in the next few years will be tilted toward consolidation rather than any real expansion.

The weak utilization rate now being observed in most industries will inevitably be felt on the economic recovery. Even if production is expected to jump in the quarters ahead, most companies will first have to make the most of their unused capacities before embarking on any kind of expansion. Under these circumstances, we can’t be surprised if corporate investment remains weak, especially in non-residential construction (graph 6).

A RAY OF HOPE?
Some recently published results leave room to believe that companies are starting to adjust by upping their investments in machinery and equipment to make productivity gains. Such investments jumped by a quarterly annualized 25.6% in the summer of 2009 (graph 7), the biggest increase since 1997. Automobiles and truck purchases advanced the most, which can be explained by better buying conditions in this market. Several other types of machinery or equipment also saw sales advance significantly (graph 8 on page 4). This is especially
the case with industrial machinery, computers and other office equipment, telecommunications equipment and furniture. And since non-residential construction is still losing ground, we can consider that a good portion of these new investments were not earmarked toward developing new production capacities, but toward updating existing facilities, which is likely to lead to productivity gains. Obviously, given the major gap to be bridged, considerable efforts will still have to be made in the years ahead to improve the competitive positioning of Canadian companies. To get there, winning conditions will have to be maintained. Besides, companies will be able to benefit from lower prices for imported machinery and equipment due to the loonie’s higher value. In addition, government policies will have to continue to facilitate and encourage corporate investment, the training of the workforce in business and education.

The fact is, in the past few years, deteriorating profits were surely the main obstacle in modernizing Canada’s companies (graph 9). It’s difficult for companies to make huge expenditures when profits are slowing down or worse, declining sharply. There are many reasons for these declining profits and they are well known. On one hand, the recession at the end of 2008 and in early 2009 chiselled the profits of many companies. On the other, declining commodities prices swayed the profits of the companies that operate in this sector. Furthermore, the reduction of prices of imported goods has increased concurrence and reduced profit margins for Canadian business. Lastly, the loonie’s lively ascent dealt a significant blow to the revenues of several exporting companies, since global trade conditions often determine prices that are set in U.S. dollars. The international trade balance has in fact deteriorated considerably in the past few years. In the manufacturing sector for example—without a doubt the most hard-hit by losses due to the lack of competitiveness—profits have been less than stellar. This sector saw its operating profits decline by 47% between its cyclical peak in early 2000 and the second quarter of 2009.

Business profits seem to be improving slightly, however. Furthermore, a recent Bank of Canada survey showed that 70% of businesses expect the pace of sales growth to pick up over the next 12 months. So most industries saw their operating profits rise in Q3 2009, a major reversal compared to the widespread decline recorded at the peak of the recession. Operating profits in the manufacturing sector even surged at a quarterly annualized pace of 174% in the third quarter of 2009. This type of profit growth had not been seen in this industry since Q3 1994. Better corporate profits will obviously provide these companies with more leeway to launch large-scale investment projects.

Besides profits, Canadian companies were also severely affected by the tightening of credit conditions seen at the start of this recent financial crisis. By contrast, the corporate credit showed an annual change of 0.4% in December 2009, a net deterioration vs. the 8.2% increase recorded in the fall of 2007. This erosion of credit extended to businesses has clearly had a significant impact on investment in the past few quarters.

Some improvement is beginning to gain traction, however. First of all, corporate credit conditions eased slightly in the fourth quarter of 2009, a first since mid-2007 (graph 10 on page 5). Secondly, the recent trend in the corporate credit has turned around these past few months (graph 11 on page 5).

**CONCLUSION: THERE IS ROOM FOR OPTIMISM**

In short, if Canadian companies have been lagging far behind on the competitiveness front in the past few years, some recent developments have made room for more optimism. There seems to be a greater confluence of conditions that will drive productivity growth, and thus improve competitiveness. Certain investments that are likely to generate productivity gains are up while profits and credit are both moving in the right direction. However, while we still can’t
see solid results in the economic data, the risk is still high that, in the end, no gains will be made. It’s worth noting that productivity developments have led to many disappointments in the past few years. The gains made proved to be somewhat mixed in the period before the recession, despite significant profit advances and relatively accessible business credit.

Canadian companies no longer have a choice: they must seize the opportunity to improve their competitiveness. Given the conditions on financial markets, the strong value of the loonie is a reality the business community will simply have to deal with for the next few years. To fight against the loss of competitiveness brought on by a strong Canadian dollar, companies must get on track, modernize and reduce their operating expenses. Otherwise, it will become increasingly difficult to remain competitive when selling our products and services on international markets (especially in the United States where more than 70% of our exports are sold). In addition, Canadian companies are facing greater competition from foreign businesses in our domestic market. To maintain our market share, we will have to be keenly competitive not only with our Canadian counterparts, but against foreign firms that sell their products and services on our shores. As one of the developed nations most open to international trade, and thus more likely to feel the negative impact of its deterioration, Canada cannot afford to ignore these observations.

We therefore cannot scrimp on efforts to encourage productivity gains. Unless Canada manages to improve its corporate competitiveness, we could very well continue to lose ground on international and national markets. In this vein, the economic recovery anticipated in the next few years could be weaker than expected. In the end, the wealth and standard of living of Canadians could be diminished.

Benoit P. Durocher
Senior Economist