Will Canada benefit from the housing recovery in the United States?

Certain Canadian industries suffered serious hardships when the housing market in the United States declined between 2006 and 2009. Residential construction south of the border has been making a comeback in recent months, which will have beneficial spin-offs for Canada’s economy, but the direct benefits may not be as significant as this might suggest. At the same time, the anticipated slowdown in Canada’s real estate market will no doubt hinder the recovery in the forestry and wood products industries. That said, Canada should still be able to capitalize on the more widespread improvements in economic conditions in the United States.

THE HOUSING MARKET IN THE UNITED STATES IS UP
In an Economic Viewpoint published on July 16, 2013,1 we concluded that the housing market in the United States was recovering gradually and that it would even be able to withstand an interest rate hike, as long as the increase reflected the improvements in the overall economy. As a result, sales of existing and new homes in the United States have been rising for the past few months and an average of 906,500 new residential units have broken ground since the start of 2013, compared with 478,000 units when the market hit its trough in April 2009 (graph 1).

The benefits of the housing market’s recovery on Uncle Sam’s economy are indisputable. To what extent will the upturn in the real estate market in the United States affect Canada? The impact may be felt directly in Canadian industries that rely on demand for construction materials, or indirectly through a broad expansion in U.S. demand, while economic conditions in the United States continue to reap the benefits of the recovery in residential real estate.

THE FORESTRY AND WOOD PRODUCTS INDUSTRIES
HARD HIT
Canada was deeply affected by the difficulties in residential construction in the United States. For example, the output of lumber and wood products manufacturing declined significantly, hitting a cyclical low point in 2009 (graph 2).

All told, 60,000 jobs in these industries were wiped out between the end of 2006 and the low point in April 2009.

To survive, several Canadian producers tried to develop new markets outside the United States. As a result, Canadian exports of forestry products and logging to countries other than the United States have climbed considerably in recent years (graph 3). Today, these exports are almost seven times greater than exports to the United States. However, exports of wood products have met with mixed success in terms of diversification since the United States is still a key player. These structural changes combined with strong residential construction in Canada enabled the lumber and wood products manufacturing output to gradually inch its way back up in recent years, but production levels are still far from the heights reached before the crisis.

Some provinces were obviously more deeply affected by these difficulties, such as British Columbia, which, alone, accounts for almost half of Canada’s entire lumber output, followed by Quebec, where total production is slightly less than the output of all eight other provinces combined (graph 4). Generally speaking, the provincial data for real GDP per industry (graph 5) show that the relative weight of the forestry industry and wood products manufacturing is highest in British Columbia, Quebec, and New Brunswick.

What impact will growing U.S. demand for construction materials have on these industries? The best way to answer this question is through the input/output model. According to Statistics Canada forecasts, an increase of $1M in external demand for the forestry and logging industry generates a GDP increase of $820,000, which translates to about 10 new jobs in the overall economy. The impacts are almost the same for wood products manufacturing, where a $1M increase in external demand represents a $790,000 boost to the GDP, and almost 10 new jobs.

The benefits of increased demand in the United States for these industries are therefore significant. Unfortunately, rising demand for Canadian construction materials in the United States might only creep up slowly in the next few years. Not only will construction evolve gradually south of the border, but producers of construction materials in the United States still have a fair amount of unused capacity after several lean years, which reduces the need to import.

The domestic market is another important factor that will influence Canada’s forestry and wood products manufacturing industries in the months ahead. Most forecasters agree that a progressive downturn in the housing market will materialize across Canada in the coming months. No more wishful thinking: concerns about an overheated real estate market and its adverse effects on the debt load of Canadian households continue to make headlines. As such, the federal government and the Bank of Canada will not let their guard down as long as the housing market fails to show convincing signs of a slowdown. In this context, a fifth round of measures to limit mortgage credit might only creeping up slowly in the next few years.
through the Canada Mortgage and Housing Corporation (CMHC). Furthermore, recent signs of improvements in economic conditions in the United States lifted bond yields on financial markets, which triggered mortgage rate increases in Canada (graph 6). Sooner or later, Canada’s real estate market will inevitably cool down.

This is obviously bad news for the forestry and wood products manufacturing industries. All signs suggest that the benefits of increased demand in the United States will be offset by the negative effects of a downturn in residential construction in Canada. These industries clearly have some more difficult years ahead.

**IS AMERICA’S ENGINE SET TO REV UP?**

All is not lost for Canada’s economy since the indirect effects of a more upbeat U.S. housing market—triggered by the broad expansion in that country’s economy—will no doubt be substantial. The fact that Canada’s economy is particularly sensitive to jolts in the U.S. economy is well known, while almost 75% of our merchandise exports are bound for the United States.

The foreign activity index developed by the Bank of Canada appropriately illustrates the extent to which Canada’s international trade depends on demand south of the border. As it stands, close to half of the fluctuation in Canadian exports is due to changes in non-residential investments in the United States. Advances in U.S. consumer spending are in second place with 21%, followed by residential investments in the United States, which represent close to 18% of the index. The remainder, or about 13%, is due to foreign demand from outside the United States. Some observations must be made in light of the makeup of this index.

At 18%, the direct effects of U.S. residential construction advances may be considerable, but this is not the most significant component for Canadian exports. The bulk of U.S. demand for Canadian exports is found instead in non-residential investments. Fortunately, our most recent projections on the U.S. economy call for solid gains on the non-residential side.

All provinces will unquestionably be able to capitalize on the ramp-up in U.S. demand. However, the provinces that rely the most on exports to the United States—New Brunswick, Alberta, Ontario, Nova Scotia and Quebec—are poised to reap the biggest benefits (graph 7). Since exports from the manufacturing sector are hugely important for the central provinces and the Maritimes, these regions could reap the lion’s share of the benefits from an expected rise in non-residential investment in the United States.

**EXPORTS SET TO RISE, BUT MANY DIFFICULTIES REMAIN**

Canada’s economy will undoubtedly benefit from the real estate market’s slow but steady recovery in the United States, and by extension, the broader improvements in economic conditions south of the border. As such, Canadian exports should rise significantly in the coming quarters, thus enabling the trade deficit to keep narrowing. There is no denying however that several obstacles remain in the short term. Global economic growth is still fragile despite some more encouraging signs from Europe. The United States is still the source of some concerns—from fiscal issues to the eventual process of firming up monetary policy. Also, the loonie’s value is likely to remain high, meaning that Canadian companies will face bigger challenges in terms of productivity gains. While indeed a positive turn, the recovery of the housing market in the United States is clearly not the cure-all for Canada’s economy.

Benoit P. Durocher
Senior Economist