Upward Pressure on Business Costs in Quebec

With the Quebec economy showing excellent growth and the United States–Mexico–Canada Agreement (USMCA) slated for ratification soon, the conditions appear to be particularly favourable for businesses. However, a number of factors are contributing to an increase in business costs, including rising interest rates, faster wage growth, energy costs and costs for certain materials. U.S. protectionism in relation to some countries, which notably led to an escalation in tariffs with China, may also drive up input costs for a number of Quebec manufacturers. Unless they raise their prices, which is difficult given global and even sometimes local competition, many businesses will see their profit margins shrink. Here is an overview of the main costs that are rising for businesses.

The Labour Costs Issue

The employee payroll accounts for a significant share of businesses’ financial obligations. For many years, wage increases were near the annual inflation rate, that is, the increase in the cost of living. Employees therefore expected to receive a raise of 1.0% to 2.0% every year, an adjustment also foreseeable for businesses (graph 1).

The situation has changed completely since 2017, as Quebec’s economy is now at full employment. The unemployment rate is around 5%, a monthly 40-year low. Nearly all regions of the province are now posting levels below 6%. Many industries across Quebec are therefore facing labour shortages. The number of vacancies in SMEs has soared over the past year (graph 2), which has led to a significant acceleration in wages. They jumped close to 3% from last year, with growth of around 4% on track to be recorded this year. While this situation is positive for workers, businesses must absorb higher labour costs.

The fact that employers are having more difficulty filling available positions, which coincides with the acceleration in wages over the past year, is reflected in the concerns expressed by businesses. According the Canadian Federation of Independent Business (CFIB) survey,1 the quicker rise in the employee payroll is becoming a problem for a growing number of SMEs (graph 3 on page 2). Approximately half of SMEs identified this as a constraint in the past, but this proportion climbed to over 60% in the fall of 2018. This problem is not unique to Quebec; it has also begun

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to spread across many parts of the country, including Ontario. In both provinces, salary expenses are the main source of pressure on costs in more than 60% of businesses.

**More Pressure on Wages: A Challenge for Productivity**

Given that the number of vacancies in the private sector is higher in Quebec than in other provinces, it is not surprising that wage growth is fast (graphs 4 and 5). Although Quebec nonetheless trails Ontario and Canada as far as average employee compensation is concerned, it is catching up. With salaries rising faster in Quebec and the gap with the rest of the country narrowing, the comparative advantage for businesses when it comes to labour costs is also shrinking.

unless more substantial productivity gains are made, through acceleration in the digital shift in particular, the competitiveness of SMEs will gradually crumble. However, Quebec appears to be on the right track in the manufacturing sector. According to the Business Development Bank of Canada (BDC), Quebec manufacturers are adopting Industry 4.0 technologies at a much higher rate than other Canadian businesses.\(^2\) Quebec even has the highest digital maturity level in Canada, at 26% of businesses. The implementation of cutting-edge technology fosters stronger sales and profit growth in all regions and across all business lines. Businesses must therefore continue in this direction in order to become more profitable and keep their competitive positioning.

Is this enough to offset the upward pressure on labour costs? Businesses that make productivity gains can absorb some of these costs, but absorbing them all is more difficult. If this were the case for most of them, SMEs would not be as concerned by the acceleration in employee wages. This is the main constraint for businesses in terms of costs (graph 6).

**Rising Energy Costs**

Higher energy prices have a variety of impacts on SMEs, including the cost of transporting inputs and finished products, the cost of heating certain buildings and the cost of some petroleum-based materials, such as plastic for packaging.

therefore affects businesses’ entire production chain, from supply to distribution. A significant proportion of SMEs in Quebec—close to 40%—believe that energy-related expenses put additional pressure on their costs. This concern ranks third after salary expenses, followed by tax and regulatory costs. Rising oil prices after few years of weakness are also worrying a growing number of businesses (graph 7). All indications are that businesses will be dealing with still higher energy-related costs next year.

In early spring, the barrel price of WTI (West Texas Intermediate) oil was the highest it has been since November 2014. While it was above US$75 in early October, it fell back down to around US$50. The U.S. administration’s decision to temporarily allow certain countries to continue to import Iranian oil contributed to this price drop, which is also a reflection of a generally negative sentiment on the financial markets.\(^3\) There is no indication that oil supply will outstrip demand for long. Rather, the expectation is that the Organization of the Petroleum Exporting Countries (OPEC) will act quickly to restore balance to the market. That should raise oil prices in the coming months. Our forecasts for oil prices are based on the premise of a fairly rapid return above US$60 per barrel. All indications are that businesses will be facing higher energy costs again next year.

More Heavily Indebted Businesses Are Suffering
For the time being, borrowing costs are low on the list of concerns for Quebec SMEs. After a decade of extremely low interest rates, some businesses appear to have forgotten that interest charges sometimes eat up a significant share of expenses. With financing costs having stayed low for a long time as well, heavily indebted businesses devoted only a small part of their budget to paying interest on their loans. Many worry about the impact that higher interest rates will have on household finances, but some businesses might also feel squeezed.

The amounts involved may be fairly sizeable. For example, an SME with $10 million of debt will have to absorb an additional $100,000 in interest charges when renewing a loan at maturity at a rate that is 1% higher than the initial rate. The Bank of Canada key rate has already climbed by 25 basis points five times since mid-2017, with two further increases planned for next year. Although it may not sound like much, this will be almost an additional 200 basis points that businesses will have to absorb when renewing loans.

When interest rates were excessively low, businesses with large loans enjoyed a reprieve from finance costs. Those days are gone. Higher financing costs will widen the gap between businesses with very little or no debt and those with higher debt, which will have to make larger interest payments. This could make some SMEs less profitable unless they can reduce their debt load. Business credit growth should also slow in Quebec next year, as has already been the case in Canada (graph 8). Will climbing interest rates lead to more business insolvencies? Not necessarily, because the economic environment will remain favourable. One thing is certain: the low interest rates of recent years and the economic growth cycle drove the number of business bankruptcies down (graph 9).

\(^3\) A Large Surplus on the Global Oil Market Is Unlikely in 2019
Will Profit Margins Be Squeezed?
Given that the increases in many types of costs, such as employee wages, interest charges on loans and energy prices, are expected to continue in 2019, corporate profitability may be affected. However, some sectors have less leeway than others. Business profit margins also vary widely by industry in Canada (graph 10). Retail and wholesale trade as well as accommodation and food services are already operating on very tight profit margins. These labour-intensive industries are deeply affected by the labour shortage putting upward pressure on wages. Some retail trade players with deeper pockets are able to offer higher wages to attract and retain employees. The situation consequently becomes more difficult for other merchants, who must maintain their break-even point.

Even though the transportation and warehousing industry has relatively high profit margins, higher energy prices will hit it particularly hard. The cost of fuel for road vehicles will be added to wages and borrowing costs, which will also be higher than before.

The manufacturing sector, with profit margins comparable to those of non-financial industries as a whole, is also facing a serious labour shortage. In addition to higher wages, the increase in energy prices affects costs at almost all stages of the production chain. Steeper interest charges for future loan renewals will also raise the financial expenses of manufacturing businesses. However, some of the tax measures announced by the federal government on November 21st will give manufacturers investing in machinery and equipment a little breathing room.4

GRAPH 10  
Profit margins* by industry in Canada

GRAPH 11  
Business profits are stable in Quebec

Even though the economic environment is currently favourable for businesses in Quebec, corporate profits have tended to stagnate over the past few quarters (graph 11). Do businesses have the financial capacity to absorb the various cost increases? This is more difficult in certain industries that already have slim profit margins, particularly those that are labour-intensive and have a fair amount of debt. The stiff competition that industries face oftentimes prevents them from adjusting sales prices. Unless they make sufficient productivity gains, many businesses will be forced to trim their profit margins.

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