

economic LETTER

MARCH 2013



THE RETURN OF MANUFACTURING TO THE UNITED STATES

Declining employment in the American manufacturing sector has been with us for a while, as shown by the graph below. It is mainly due to increasing mechanization of production in the first decade of this century, and to China's entry into the World Trade Organization in 2001. As a result, the American manufacturing sector lost 5.8 million jobs over this period. The abundance of cheap labour in China lured away a large portion of manufacturing production from the United States—and from other industrialized countries, including Canada—to that country. But the winds are starting to shift, and the manufacturing sector may well “come home” in the near future, according to some American analysts.¹

This theory is supported by many factors. Firstly, the wages of Chinese workers have risen substantially over time: their average annual growth reached 10% between 2000 and 2005, and accelerated to 19% between 2005 and 2010. This trend should continue in the years ahead, and could even intensify. Secondly, China's labour productivity is below that of the United States. It has improved considerably in recent years, and will no doubt keep doing so, but wages are increasing even faster. Consequently, the variance in labour cost per unit of output between China and the United States is shrinking with each passing year. Thirdly, wages have not only increased far less in the United States than in China, they have even declined in some manufacturing sectors, which also helps narrow the gap between Chinese and American wages. In short, China's main competitive advantage, cheap labour, is gradually disappearing.

At this point, the cost of labour is still far lower in China than in the United States (China's unit labour cost was 31% of that of the United States in 2010). But we need to remember that this represents only a portion of the total cost of manufactured goods. If we take into account the other costs—transportation, energy, taxes, real estate in the industrial sector—which keep rising, the savings to be gained by moving production to China could disappear in many American manufacturing sectors in the years to come. According to some analysts, in most cases, the decision to move manufacturing back to the United States to be nearer to the customer base has even more to do with transportation costs, energy prices and exchange rate fluctuations than with the narrowing of the gap between Chinese and American labour costs.² ▼

¹ The Boston Consulting Group (2011), *Made in America, Again—Why Manufacturing Will Return to the U.S.*; The Boston Consulting Group (2012), *Made in America, Again—U.S. Manufacturing Nears the Tipping Point—Which Industries, Why and How Much?*

Canada

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- > Employment rallies
- > The trade deficit shrinks slightly
- > Housing starts keep heading down
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United States

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No change in sight for the key interest rate over the next several months

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BDC's Monthly Economic Letter is prepared by the Economic Analysis team from Marketing and Public Affairs and is based on a variety of public sources of economic data. The information in this letter is drawn from data released prior to March 9. Reliance on and use of this information is the reader's responsibility.

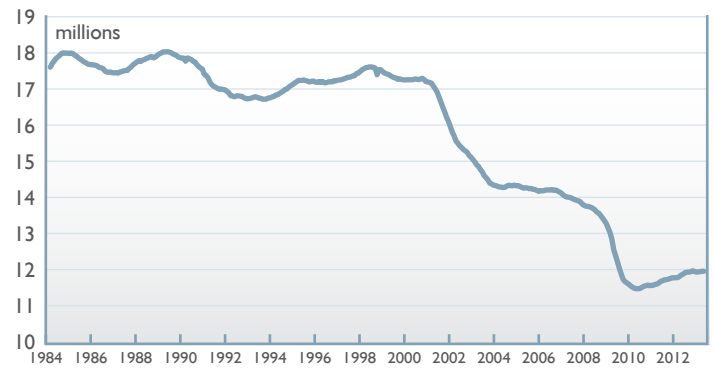
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Having said that, not all businesses would stand to gain from repatriating their production to the United States. The ones that would are mainly those whose production is less labour-intensive and for which logistical issues, such as delivery costs and times and the proximity of production sites to engineering and design teams, are important. The Boston Consulting Group (BCG) has identified seven manufacturing sectors where it will become more economical, in its view, to relocate production to the United States in five years or so: transportation, machinery, computers and electronic products, electrical devices and equipment, furniture, metal products, and plastic and rubber products. This does not mean that these businesses will cease their Chinese operations. They could earmark their Chinese production for the Asian market, which is booming; but it would be more economical for them to serve the American market from facilities located in the United States.

BCG estimates that between 10% and 30% of the products in these seven sectors that are currently imported from China for the American market could be produced in the United States by the end of this decade. This would add \$20 to \$50 billion annually to the U.S. economy and create thousands

of direct jobs in the manufacturing sector, which in turn would generate thousands of jobs in other economic sectors. These forecasts are based on many assumptions, in particular regarding labour cost trends and the price of energy, and must therefore be taken with a grain of salt. But they do offer hope of a better future for the American manufacturing sector. ■

Employment in the U.S. manufacturing sector (January 1984 to January 2013)



Source : U.S. Bureau of Labour

CANADA

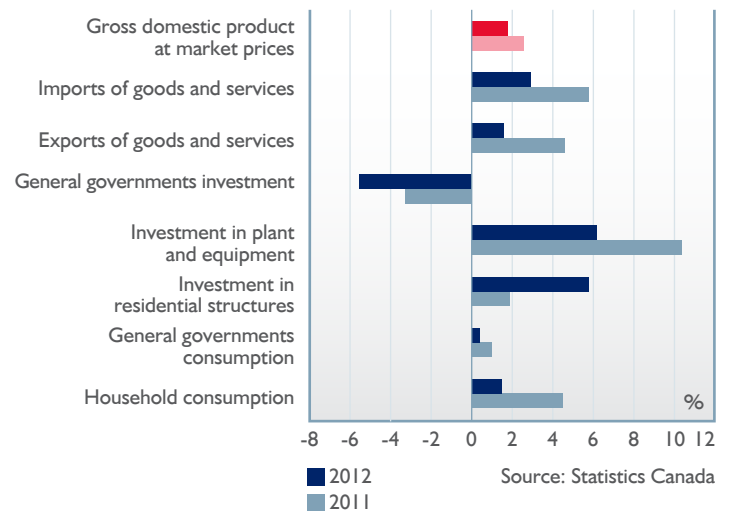
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Economic growth turned out to be very modest in 2012: real GDP rose by just 1.8%. Employment made solid gains last year, but the unemployment rate remained high. The hiring intentions of SME owners for the months ahead are up, which is encouraging. Forecasters are nevertheless expecting real GDP to grow at the same pace in 2013 as in 2012; we will have to wait until 2014 for growth to accelerate.

Real GDP advances by baby steps

Real GDP recorded annualized quarterly growth of just 0.6% in the fourth quarter of 2012, following a similar result in the previous quarter (0.7%). A slowdown in stockpiling held growth in check, while the contribution from foreign trade was practically nil, and domestic demand made solid headway (2.6%). Consequently, real production growth reached a mere 1.8% in 2012, compared with 2.6% in 2011. Apart from investment in homebuilding, which reported growth much stronger than anticipated, all the components of GDP showed weaker growth in 2012 than in 2011 (Graph). According to the Consensus Forecasts, economic growth will stay at that pace in 2013 (1.8 %), but should accelerate in 2014 (2.4 %). ▼

Growth in the main components of real GDP in 2011 and 2012 (Annual Change)



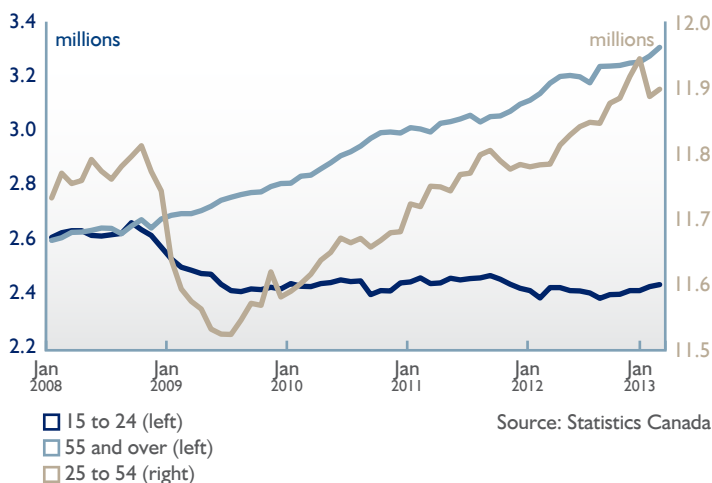
Source: Statistics Canada

2 Pricewaterhouse Coopers (2012), A homecoming for United States manufacturing? – Why resurgence in U.S. manufacturing may be the next big bet.

Employment rallies

After tumbling by 21,900 jobs in January, employment increased by 50,700 jobs in February. The gain was divided between 33,600 full-time jobs and 17,200 part-time jobs. The professional, scientific and technical services sector recorded the sharpest increase in February (26,200), while manufacturing suffered the greatest drop (-25,600). Workers aged 55 and up achieved the largest gains. It should be noted that in tandem with the aging of the population, employment in this age group has risen significantly in recent years (Graph). In February 2013, workers aged 55 and over accounted for 19% of all jobs, compared with just 14% five years ago.

Employment by age group (January 2008 to February 2013)



Housing starts keep heading down

Housing starts spurted by 13.7% in February compared with the previous month. In urban centres, the number of housing starts rose by 6.1% in the single-family sector and by 27.7% in the multiple-unit sector. Ontario and Quebec saw the sharpest growth in February (46.8% and 34.9% respectively). Despite this monthly gain, the downwards trend of housing starts over a six-month horizon is continuing, as predicted by the Canada Mortgage and Housing Corporation (Graph).

Housing Starts (January 2008 to January 2013)



The trade deficit shrinks slightly

Exports rose slightly more than imports in January (2.1% versus 1.9%), with the result that the trade deficit shrank somewhat, from \$332 million in December to \$237 million in January. With a few exceptions, the trade balance has remained stuck in negative territory since the beginning of 2009. Competition from the emerging countries and the strong Canadian dollar are continuing to curb growth in exports and stimulate imports. Forecasters are counting on a strengthening U.S. economy to stimulate Canadian exports in 2013 and 2014.

The leading indicator stays positive

With an uptick of 0.2% in January, the leading indicator compiled by the MacDonald-Laurier Institute tells us that the Canadian economy will keep growing in the months ahead. The leading indicator received a positive contribution from the components that are most closely tied to demand for Canadian exports (i.e. the new orders index and the American leading indicator); meanwhile, the housing index, which mainly reflects a downturn in housing starts, constitutes the greatest drag on the indicator's growth. ■

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The most recent economic indicators are positive: employment keeps heading up, housing starts have turned the corner and business confidence is on the upswing. That said, all this is happening slowly, and the economy remains fragile. Forecasters are calling for growth of just 1.9% in 2013, which should accelerate to 2.8% in 2014.

Employment keeps expanding

Employment reported 236,000 new jobs in February, and the unemployment rate dropped to 7.7%. Despite the upturn in employment since the beginning of 2010, the unemployment rate is still far higher than where it stood before the recession (around 4.5%). The job market is improving, but very slowly. The number of “discouraged workers” (people who have stopped looking for work because they are convinced they will not find any) is still following a downwards trend, but the number of people who are working part time for economic reasons (for instance, because they are not succeeding in finding full-time work) is still high (Graph).

Discouraged workers and persons employed part-time for economic reasons (12-month moving average)

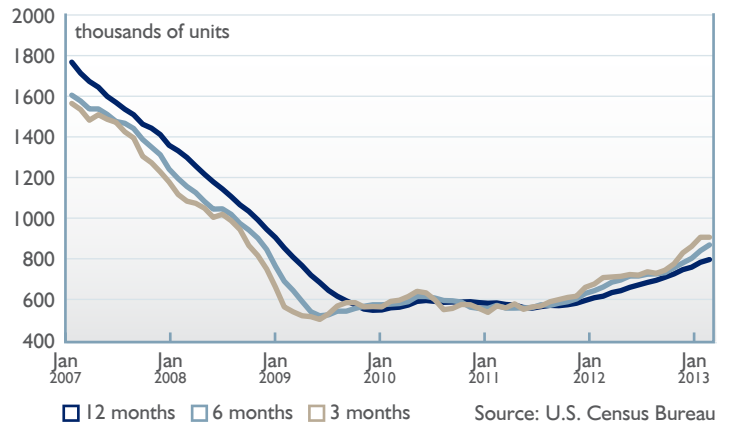


The housing sector is still gaining ground

Housing starts fell by 8.5% in January compared with the previous month. The decline is entirely attributable to a plunge in starts of multiple-unit homes (-26.1%), since the number of single family starts was relatively stable (+0.08%). Given the volatility of monthly data, it behooves us to examine housing start trends over a longer period of time. In doing so, we note that the trend is upwards, whether we look at a horizon of three, six or twelve months (Graph). In the resale market, the recovery is continuing. Sales of existing homes rose by 0.4% in January, from December, and home prices are still increasing. The inventory of homes is still contracting: in January, it would have taken 4.2 months to sell off the inventory of homes at the current pace of sales. That is the lowest number seen since April 2005.

Housing Starts

(moving averages over different time periods)



Confidence strengthens in the manufacturing sector

The Institute for Supply Management’s Purchasing Managers’ Index for the manufacturing sector, which had slipped below the 50 mark in October 2012, has gradually climbed back up since then. In February it gained 1.1 points to reach 54.2, a ten-month peak (it stood at 54.1 in April 2012). The vast majority of the index’s components are up, apart from the employment index, which nevertheless managed to stay above 50. The February data give reason to believe that the economy, especially the manufacturing sector, is gaining strength. ■

The key interest rate remains static

On March 6, the Bank of Canada decided once again to leave the benchmark interest rate at 1.0%. According to the central bank, the Canadian economy is following a path that is consistent with the Bank's projection stated in its January Monetary Policy Report. Given that unused production

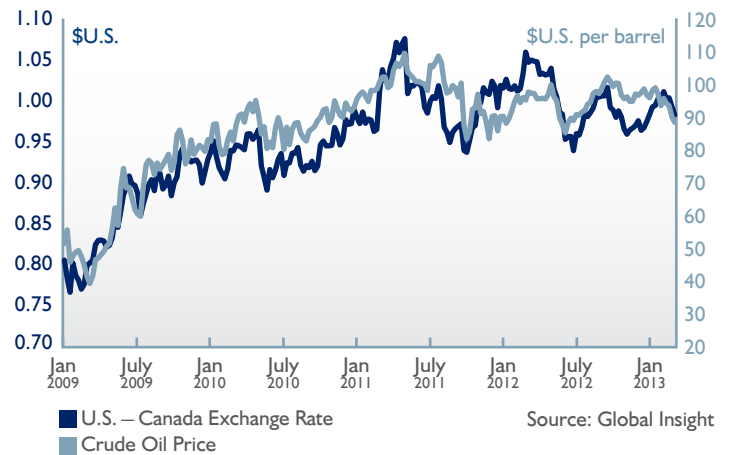
capacity in the economy remains quite high, inflation is weak and household debt appears to be contained, the Bank of Canada feels that in order to reach the inflation target of 2.0%, it will be appropriate to leave the interest rate at that level for a while to come, before raising it gradually. ■

OIL AND THE LOONIE

The price of oil loses ground and the Canadian dollar depreciates

The price of oil has slumped in recent weeks. Many factors are behind this: larger-than-expected inventories in the United States, budget cuts that have taken effect in that country, and worries about what effect the death of Hugo Chavez may have on the future oil policy of Venezuela, the sixth largest producer within the Organization of the Petroleum Exporting Countries (OPEC). Meanwhile, the price of Western Canada Select heavy crude is down, due to the persistent congestion of transportation infrastructures, while production continues to accelerate; this has driven the Canadian dollar down against its American counterpart. ■

Price of Oil and the Canada – U.S. Exchange Rate

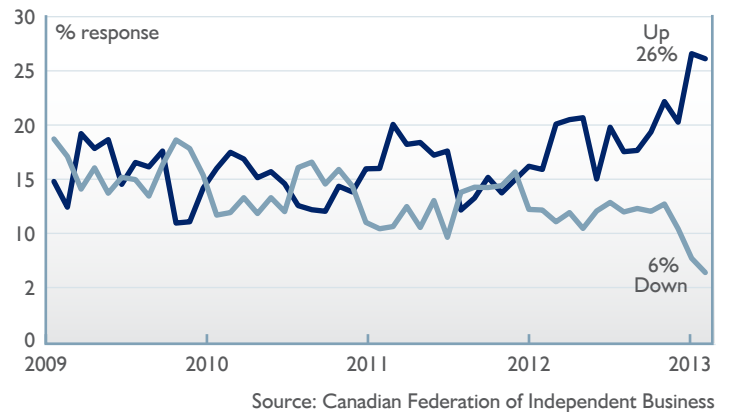


SME CONFIDENCE

Business confidence is still strong

After rebounding by 3.1 points in January, the Canadian Federation of Independent Business (CFIB) Business Barometer Index gained another 0.5 point in February to reach 66.2. The February number leads us to believe that the economy is nearing its full potential, if it is not there already (according to the CFIB, the index usually varies between 65 and 70 when the Canadian economy reaches its full growth potential). Once again, the numbers relating to hiring outlooks are especially encouraging: the percentage of businesses that expect to hire full-time staff in the next three to four months has been on a strong upwards trend for several months now, while the percentage of those that expect to lay workers off is down (Graph). ■

Intention to add full-time staff within 3 or 4 months





BUSINESS CREDIT CONDITIONS

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Bank credit is up

After a rally in December 2012, monthly growth in credit granted to businesses by the chartered banks moderated in January; short-term credit expanded by 10.5% compared with the previous month, while long-term credit rose by 9.2%. The effective interest rate (a weighted average of various bank and market interest rates that apply to new loans granted to non-financial businesses) remains stable and low, oscillating around 3.2% over the past several months (Graph). ■

Effective Business Interest Rate
(January 2007 to January 2013)



Source: Bank du Canada



KEY INDICATORS – CANADA

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Key indicators – Canada	Historical				2012				2013	Forecasts		
	2009	2010	2011	2012	Q1	Q2	Q3	Q4	Latest	2013	2014	
Real GDP (% growth)	-2.8	3.2	2.6	1.8	1.2	1.9	0.7	0.6	Jan	-0.2	1.8	2.4
Machinery and Equipment Expenditures (% growth)	-20.4	13.7	10.7	3.7	6.5	0.1	2.1	1.2			4.6	6.9
Pre-Tax Corporate Profits (% growth)	-48.9	70.4	22.8	-3.1	-24.0	-19.4	1.3	18.2			3.2	5.6
Industrial Production (% growth)	-10.9	6.3	3.8	1.2	-0.9	2.3	-1.7	-1.2	Jan	-1.1	1.8	2.7
Industrial Product Prices (% growth)	-3.5	1.0	4.6	0.6	0.9	0.9	-2.5	0.1			1.1	2.3
Non-Residential Construction (% growth)	-18.6	15.0	10.2	8.0	9.2	14.5	-2.1	6.5				
Housing Starts (' 000 units)	148	191	193	215	205	231	222	202	Feb	181	180	175
Personal Expenditures (% growth)	0.1	3.5	2.4	1.9	2.2	0.5	2.8	2.7			2.1	2.2
Consumer Price (% growth)	0.3	1.8	2.9	1.5	2.0	0.2	0.1	1.4	Jan	0.1	1.5	2.0
Employment (% growth)	-1.6	1.4	1.5	1.2	0.8	2.6	0.6	2.4	Feb	0.3		
Unemployment Rate (%)	8.3	8.0	7.5	7.3	7.4	7.3	7.3	7.2	Feb	7.0	7.2	7.0
SMEs Confidence Index (CFIB)	57.7	66.7	66.4	63.9	66.3	64.4	61.0	63.7	Feb	66.2		
Manufacturers Confidence Index (CFIB)	56.0	68.6	67.2	66.7	69.0	67.2	65.3	65.2	Feb	67.0		

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business. Annual growth, quarterly growth at annual rate and month-over-month growth.