BDC
Entrepreneurs first

economic LETTER

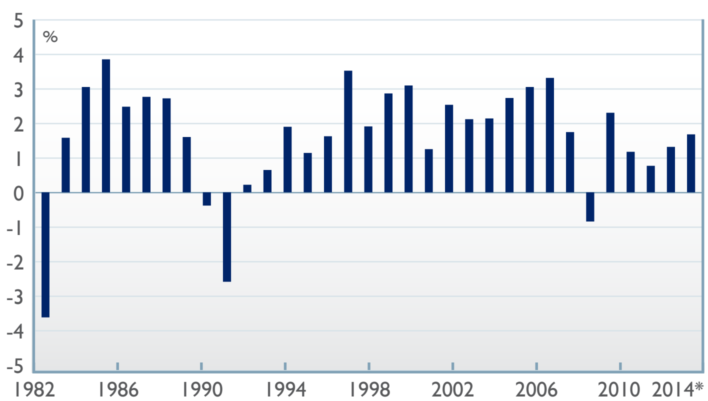
FEBRUARY 2015

HOUSEHOLD CONSUMPTION IN 2015: UP OR DOWN?

Household consumer spending is the largest component of Canada's gross domestic product (GDP). In 2014, it amounted to a little over $1 trillion,[1] or 54% of the value of GDP. Consequently, its growth has a considerable bearing on that of the economy as a whole.

Generally, consumer spending grows over time, because the population expands and prices rise. That said, even if the data are adjusted to take population and price growth into account, we note that they almost always increase from year to year (graph). Declines are rare: they happen in periods of recession.

Real household consumption expenditure per capita
(Annual change, 1982 to 2014)



*The three first quarters of 2014 compared to the three first quarters of 2013

Source: Statistics Canada

To understand the reasons behind this almost continuous growth in real consumer spending per capita, we can use the analogy of individual consumption. Every person has three ways in which to increase his or her spending: increasing income, reducing savings (which means consuming a larger share of income), and borrowing.

1 One trillion is equal to a thousand billion.

Over the past twenty years, Canadians' real consumer spending has increased faster than their real disposable income.[2] In fact, between 1990 and 2014, consumer spending expanded by an average of 2.7% per year, versus 2.4% for income. The share of disposable income allocated to consumer spending climbed from 88% to 95% during that period, and the household debt ratio, measured by household credit in proportion to disposable income, nearly doubled, from 86.8% in 1990 to a peak of 163.8% in 2014.

Now, is it possible to predict what Canadian household spending will do in 2015? Actually, not all the winds are blowing in the same direction: some factors will stimulate consumption, while others will rein it in. The stimulating factors include low interest rates. For several years already, the extraordinarily low level of interest rates has increased households' borrowing capacity, enabling them to consume more. To combat the negative effects of plunging oil prices on the Canadian economy, the Bank of Canada has just cut the key interest rate. That means that borrowing costs will remain low and will keep stimulating consumption this year.

The crude oil price slump will also have consequences on household spending, some of them positive, others negative. One positive consequence stems from the lower energy costs that will ensue. Households will be able to reallocate the funds freed up by savings on fuel and heating oil to the purchase of other goods and services.[3] This will mean more growth in real household spending.

However, the collapse in oil prices is likely to slow Canada's economic growth, especially in the oil sector and related industries. Employment—and therefore income—will probably suffer as a result, and slow consumption. That said, lower oil prices put downwards pressure on the Canadian dollar, which stimulates activity in exporting industries. They also benefit from the strengthening of economic growth in the United States. These two effects—the depreciation of the Canadian dollar and accelerating growth in the United States—can already be seen in the data on Canadian exports of manufactured goods to the United States: they are up sharply. It is by no means certain that the renewed vigour of non-oil export sectors will counterbalance the slowdown in the oil sector and related industries, but it will no doubt mitigate the negative effects of lower oil prices on employment and income and, therefore, on consumption.

One last factor to take into consideration, as far as outlooks for growth in household consumption are concerned, is the high debt ratio that households currently have. Even though interest rates are low, some households might decide to reduce their debt by consuming less. Meanwhile, some households, especially those that are likely to be hit close to home by the slowdown in the oil industry, may opt to squirrel away a portion of the money they save thanks to lower energy prices, rather than increase their consumption of other goods and services.

Taking all these positive and negative factors into consideration, it appears that even though consumption growth will slow in 2015, it will nevertheless remain positive and relatively solid. According to the most recent economic forecasts, growth in household consumer spending, estimated at 2.8% in 2014, will decline to 2.4% in 2015.[4] ■

2 A household's disposable income consists of all the household income (including work compensation and government transfer payments) minus income tax and contributions to social insurance plans.

3 In 2014, the average price of regular gasoline rose to $1.28 per litre in Canada. It currently stands at $0.92 per litre, a difference of $0.36 per litre. Were the price to stay at that level in 2015, the annual saving enjoyed by a consumer who fills a 30-litre gasoline tank every week would come to $561.60.

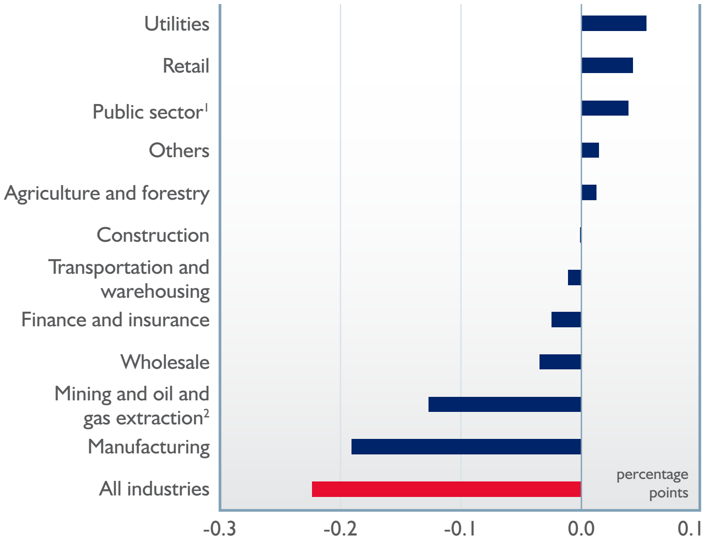
4 This figure is taken from the Consensus Forecast of January 12, 2015. The financial institutions that have published updated forecasts of consumer spending growth since the key interest rate cut of January 23, i.e. TD Bank, RBC Royal Bank and BMO Bank of Montreal, are predicting, on average, 2.5% growth in consumer spending in 2015.

The effects of the recent crude oil price slump on the Canadian economy are beginning to show up in the data: production pulled back in the oil sector in November, the drop in energy products curbed export growth in December, and employment declined in the natural resources sector (which includes the oil sector) in January. The other sectors of the economy should fill the breach and support growth in 2015.

Contraction in GDP

After expanding by 0.3% in October, real GDP contracted by 0.2% in November. This contraction is mainly attributable to shrinking output in manufacturing, mining and the oil sector. Given the oil price slump, the decline in activity in that sector is not surprising, and it could continue in the months ahead. On the other hand, the slowdown in manufacturing output is surprising, given the strengthening of the U.S. economy and the depreciation of the Canadian dollar. However, it is reasonable to assume that this is a temporary downturn, and that manufacturing production will resume its upwards course in the coming months.

Main industrial sectors' contribution to the percent change in GDP, November 2014



1 Education, health and public administration
2 Includes quarrying

Source: Statistics Canada

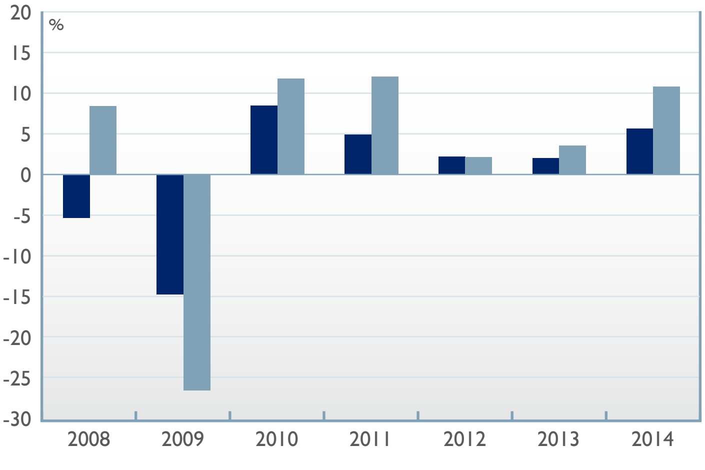
Employment wins back the ground that was lost

In January, employment won back the ground that had been lost in the previous two months, expanding by 35,400 jobs. This gain comes entirely from part-time jobs, which increased by 47,200, while 11,800 full-time jobs were lost. The unemployment rate dipped by one tenth of a percentage point in January, to 6.6%. It was the professional, scientific and technical services sector that recorded the sharpest increase in jobs in January: a gain of 22,400 jobs, the largest in several months. The natural resources sector suffered the largest job loss in January. This is probably linked to the recent oil price slump, which should generate a slowdown in the oil sector. Negative repercussions on employment, not only in that sector but also in related industries, are to be expected.

The trade balance worsens

In December, imports rose by 2.3%. Exports also headed up, but at a slower pace of 1.5%. Consequently, the trade balance deteriorated, with the deficit widening from $335 million in November to $649 million in December. The lower prices for energy products, caused by the crude oil price slump, curbed export growth. Once adjusted to reflect price variations, exports expanded by 3.5% in December. In 2014 as a whole, the value of exports climbed by 10.8%. Exports headed to the United States were up by 11.6%, while those to other countries rose by 6.5%. A significant portion of export growth stems from higher prices; in terms of volume, it was not as strong, at 5.7%, but this is nevertheless a solid acceleration compared with 2012 and 2013 (graph).

Real and nominal exports
(Annual change, 2008 to 2014)



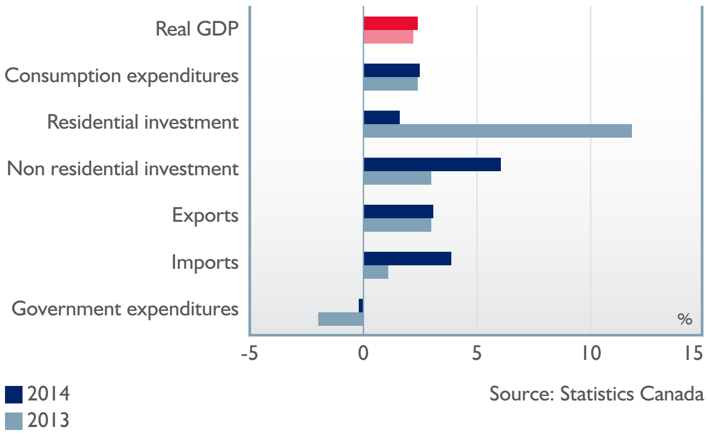
Source: Statistics Canada

The latest data are still showing strengthening economic activity in the United States. Consumption recorded sharp growth in the last quarter of 2014, which no doubt reflects improvement in the job market. Furthermore, acceleration in non-residential investment in 2014 bodes extremely well for job growth in 2015.

GDP growth rose slightly in 2014

Real GDP grew by 2.4% in 2014, compared with 2.2% in 2013. Consumer spending increased at approximately the same pace during those two years (graph). On the other hand, residential investment growth was substantially lower (1.6% in 2014 versus 11.9% in 2013). This slowdown was largely offset by acceleration in non-residential investment, where growth rose from 3.0% in 2013 to 6.1% in 2014. Growth in exports was flat in 2014, but that of imports accelerated to a significant degree. Lastly, government spending, which had been reduced in 2012 and in 2013 in an effort to repair public finances, remained relatively stable in 2014 and thus did not slow GDP growth. According to the latest forecasts, real GDP should grow by 3.2% in 2015.

Real GDP and its main components
(Annual change in 2013 and in 2014)

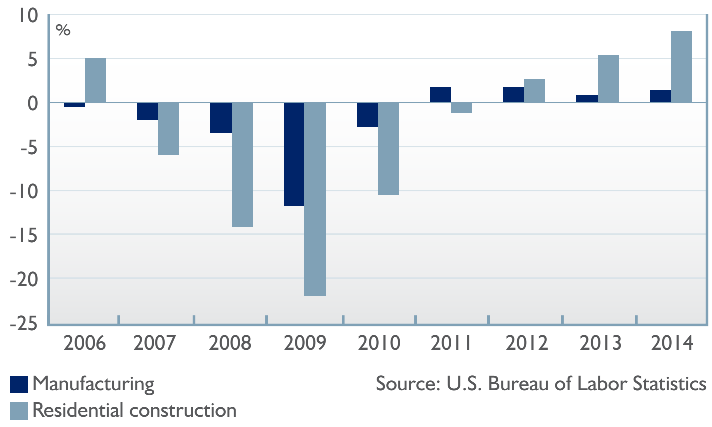


Source: Statistics Canada

Job growth remains solid

Non-farm employment expanded by 257,000 jobs in January, after gains of 329,000 jobs in December and 423,000 in November (the November and December data were revised upwards based on additional information that was received after the last release and after the annual seasonal adjustment). The unemployment rate came in at 5.7% in January, compared with 5.6% in the previous month. Retail trade, construction, health care services and manufacturing were the sectors that recorded the largest gains in January. Employment in home building and manufacturing is picking up steam, but the pace of recovery is slow compared with the losses that were sustained during the recession (graph).

Employment in the manufacturing sector and in the residential construction sector
(Annual change, 2006 to 2014)



Source: U.S. Bureau of Labor Statistics

Housing starts head up

Housing starts were up by 4.4% in December compared with the previous month. They climbed by 7.2% in the single-family dwelling segment, but dropped by 4.2% in the multiple-unit segment. In 2014 overall, housing starts increased by 8.8%, compared with 18.5% in 2013. In 2015, housing start growth should head up. The expected acceleration in economic activity will generate higher employment levels and income, and lending conditions will remain favourable, which should stimulate home ownership for a larger number of households.

INTEREST RATES

Back

The Bank of Canada lowered the key interest rate in January

On January 21, the Bank of Canada lowered the key interest rate by 25 basis points, bringing it to 0.75%. The central bank made this decision to mitigate the effects of the recent crude oil price slump on economic growth and inflation. According to the Bank, real GDP growth will slow during the first half of 2015, but will pick up in the second half, when the positive effects of a stronger U.S. economy, a weaker Canadian dollar and a more stimulative monetary policy will make themselves felt. The Bank predicts that real GDP growth will reach 2.1% in 2015. According to many forecasters, the central bank could cut the target for the overnight rate by another 25 basis points on its next rate-setting date, March 4.■

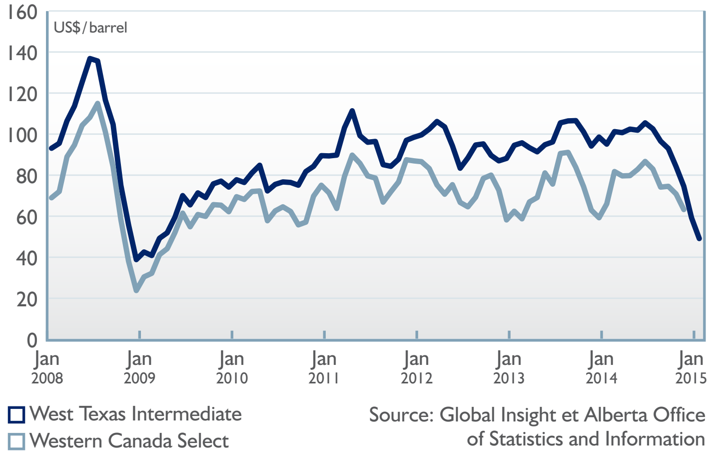
OIL PRICE

Back

Crude oil prices keep falling

After plunging by 20.7% in December, the price of crude oil, as measured by that of West Texas Intermediate, tumbled by 17.4% in January to reach a monthly average of US$48.64 per barrel. The abundant global supply, combined with anticipated weak demand, are the main factors behind the January price slump. But prices have headed back up recently, surpassing the US$50 per barrel mark, after an announcement that the number of oil platforms in operation in the United States had been reduced. Meanwhile, the deferral of many oil investment projects is stoking expectations of a future contraction in the supply, which is also putting upwards pressure on oil prices. That said, prices are highly volatile at present, and the recent rally could well prove temporary.■

Price of crude oil
(January 2008 to January 2015)



Source: Global Insight et Alberta Office of Statistics and Information

CANADIAN DOLLAR

Back

The Canadian dollar depreciates further

The Canadian dollar has lost 4.8% of its value against the U.S. dollar, compared with the previous month, falling from a monthly average of US$0.87 in December to US$0.82 in January (graph). The loonie's depreciation is still linked to the crude oil price slump, but it has been exacerbated by the cut in the key interest rate, which the financial markets had not anticipated. With increasingly obvious signs that the U.S. economy is gathering steam, the markets are expecting that U.S. interest rates will head up by the end of this year, whereas on this side of the border, not only is no key interest rate hike forecast before 2016, but another 25 basis point cut is possible in the next few months. These divergences between Canadian and American monetary policies are exerting downwards pressure on the Canadian dollar.■

Canada/United States exchange rate
(Monthly data, January 2008 to January 2015)

Source: Bank du Canada

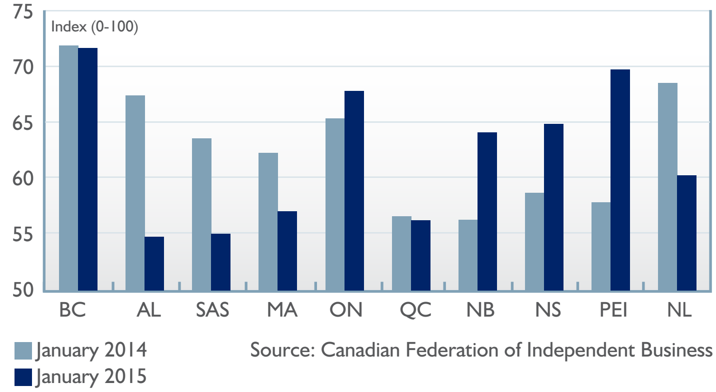
SME CONFIDENCE

Back

SME owners' confidence edges back up

The Canadian Federation of Independent Business's Business Barometer Index has risen by 1.6 points, reaching 63.5, thereby winning back some of the ground that was lost in December. The index was up in Nova Scotia, Prince Edward Island and Ontario. However, it lost 11.4 points in Alberta and 3.6 points in Newfoundland and Labrador, provinces whose economies are obviously likely to be hard hit by the crude oil price slump. In the space of one year, the regional perspectives of SME owner confidence have changed drastically: whereas in January 2014 the business owners in the Prairies were much more optimistic than those in the Maritimes, the reverse is the case in January 2015 (graph).

Business Barometer, by province
(January 2014 and January 2015)



Source: Canadian Federation of Independent Business

BUSINESS CREDIT CONDITIONS

Back

Business credit conditions are stable

According to the Bank of Canada's two surveys, the Business Outlook Survey (BOS) and the Senior Loan Officer Survey, business credit conditions in the fourth quarter did not change compared with the previous quarter (graph). The majority of the respondents to the BOS reported that it was easy or relatively easy to obtain credit. In December 2014, the credit granted to businesses by the chartered banks rose by 1.5% compared with the previous month. Short-term credit rose by 1.6%, and long-term credit by 0.7%.

Business Credit Conditions
(2004 Q1 to 2014 Q4, balance of opinions)

Source: Bank of Canada

KEY INDICATORS—CANADA

Back

Key indicators—Canada

	Historical[1]				2014[2]				Latest[3]		Forecast	
	2011	2012	2013	2014	Q1	Q2	Q3	Q4			2015	2016
Real GDP (% growth)	3.0	1.9	2.0		1.0	3.6	2.8		Nov	-0.2	2.3	2.2
Machinery and Equipment Expenditures (% growth)	8.1	1.9	-1.7		-5.0	1.4	5.2				1.5	3.5
Pre-Tax Corporate Profits (% growth)	23.3	-6.7	0.7		26.6	6.7	3.9				-1.3	5.4
Industrial Production (% growth)	4.1	1.4	1.8		5.3	4.7	0.8		Nov	-1.2	1.9	2.2
Industrial Product Prices (% growth)	6.9	1.1	0.4		12.7	0.6	-1.2		Dec	-1.6	-0.4	2.8
Non-Residential Construction (% growth)	15.9	13.5	5.0		-0.3	0.5	-1.9					
Housing Starts (' 000 units)	193	215	188	189	176	196	199	184	Jan	187	185	179
Personal Expenditures (% growth)	2.2	1.9	2.5		1.5	4.4	2.8				2.5	2.3
Consumer Price (% growth)	2.9	1.5	1.0	1.9	2.8	3.7	1.3	0.1	Dec	-0.1	1.1	2.1
Employment (% growth)	1.5	1.3	1.4	0.6	0.6	0.0	0.7	1.6	Jan	0.2		
Unemployment Rate (%)	7.5	7.3	7.1	6.9	7.0	7.0	7.0	6.7	Jan	6.6	6.6	6.5
SMEs Confidence Index (CFIB)	66.3	63.9	63.9	64.9	64.2	65.5	64.7	65.1	Jan	63.5		
Manufacturers Confidence Index (CFIB)	67.3	66.5	63.8	65.8	65.0	64.3	68.8	64.9	Jan	66.7		

1. Annual growth rate
2. Quarterly growth, at annual rate
3. Month-over-month growth

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business.