economic LETTER

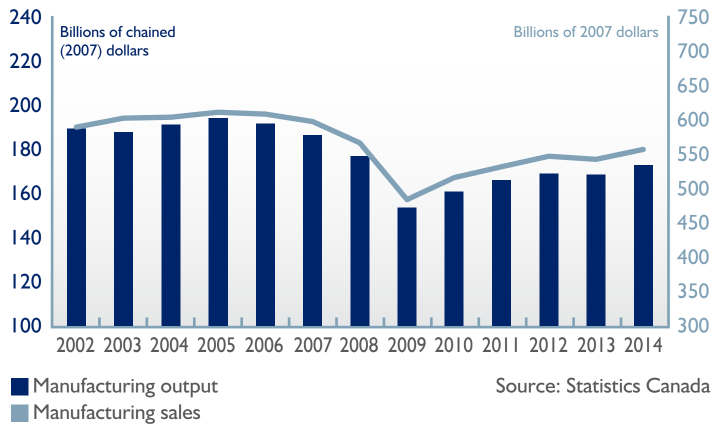
MARCH 2015

OUTLOOKS ARE IMPROVING IN THE MANUFACTURING SECTOR

Canada's manufacturing sector has seen hard times in the past 15 years. Many events have curbed growth in this sector. Competition from the emerging countries began to manifest itself at the beginning of the 2000s and gradually intensified thereafter. The Canadian dollar appreciated substantially between 2002 and 2008 amid rising crude oil prices, curtailing exports. Then, in 2009, the financial crisis broke and drove the country into recession.

Since then, manufacturing output has climbed up again, but in real terms, i.e. adjusted to reflect price increases, it is still below where it stood before the recession. The same finding holds true of the real value of factory sales (Graph 1). Manufacturing output as a share of private-sector gross domestic product has dropped significantly.[1] It tumbled from 19.4% in 2000 to 13.0% in 2009, and has been oscillating around that percentage since then.

Graph I: Real value of manufacturing output and sales (2002 to 2014)



Source: Statistics Canada

Canada

- Real GDP growth accelerated in 2014
- The oil price slump drives exports down
- Housing starts rise, but their trend is still downwards
- Falling gasoline prices drive the inflation rate down

United States

- Job growth is still solid
- Housing starts and existing home sales decline
- The annual change in the Consumer Price Index dips below zero

Interest rates

The key interest rate stays unchanged at 0.75%

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Key indicators

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 7. Reliance on and use of this information is the reader's responsibility.

1 Private-sector real GDP is estimated by taking the real GDP of all industries, and subtracting those of public administrations, healthcare and social assistance services, and educational services.

Despite this decline, manufacturing is still a pillar of the Canadian economy. In 2014, it was the second largest industry of the private sector, in terms of production.[2] The value of factory sales came in at $621 billion last year, and exports at $318 billion, which represents 61% of the total value of Canadian merchandise exports. The manufacturing sector ranks fourth as far as private-sector non-residential investment is concerned, representing close to 8%. Having slightly over 1.7 million workers, this is the sector (after retail trade) that generates the largest number of direct jobs, i.e. 12.7% of private-sector jobs. Lastly, greater activity in the manufacturing sector has many indirect effects on other sectors of the economy.

In the current circumstances of the recent plunge in oil prices and its anticipated negative repercussions on the Canadian economic activity, outlooks for growth in the manufacturing sector attract a good deal of interest. Two factors are currently promoting improvement in manufacturing growth: the strengthening of the U.S. economy, and the depreciation of the Canadian dollar against the greenback. The effects of these factors are in fact already visible in the manufacturing data shown in the table below. We note that the annual growth rates of the key indicators accelerated in 2014 compared with the previous year.

Manufacturing sector indicators, Canada

Indicator	Annual growth in 2013	Annual growth in 2014
Real GDP	-0.3%	2.6%
Manufacturing sales		
in current dollars	0.3%	5.3%
in 2007 dollars	-0.9%	2.7%
Exports (in current dollars)	1.6%	8.4%
to the United States	3.1%	10.0%
to other countries	-3.7%	6.6%

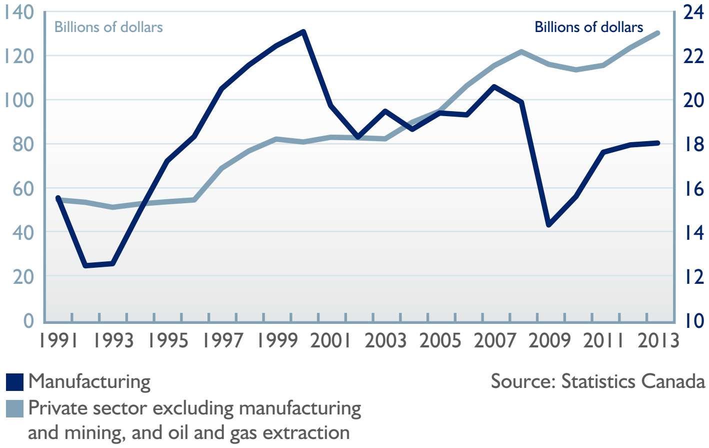
Source: Statistics Canada

This trend should continue in 2015. In fact, forecasters anticipate vigorous real GDP growth of 3.2% in the United States this year, and unless oil prices quickly head back up again, the Canadian dollar is unlikely to appreciate against the U.S. dollar.

That said, Canada's manufacturing sector is facing major challenges. First of all, the emerging countries chipped away at Canada's share of the U.S. market during the 2000s. Consequently, the vigour of the U.S. economy will not stimulate Canadian exports to the same degree that it formerly would have done. To compensate, manufacturing firms need to penetrate the emerging markets to a greater extent. In those markets, the middle class is expanding and offers enormous growth potential to many Canadian exporters.

Secondly, if it wants to be more competitive, the manufacturing sector needs to improve its productivity. That means investing more. As shown in Graph 2, this sector has suffered from underinvestment for many years now. While investment has increased almost constantly over the years in all the other private-sector industries, it lost ground in the manufacturing sector at the beginning of the 2000s and has never gained it back.[3]

Graph 2: Non-residential investment
(1991 to 2013)



Source: Statistics Canada

Higher productivity would enable Canadian manufacturing businesses not only to improve their performance, and thus become more competitive, but also to alleviate the problems of recruiting qualified manpower which are likely to result from the aging of the population. The population of working age has been growing more slowly in recent years, and this trend will continue over the next decade. The expansion of the labour pool could prove to be insufficient to meet the demand for workers. Many businesses are already facing recruitment difficulties.

In short, the outlooks for the manufacturing sector are bright in 2015. In the longer term, the industry has substantial challenges to meet to ensure lasting growth; in particular, to take greater advantage of the growing demand from emerging markets, and to improve its productivity. ■

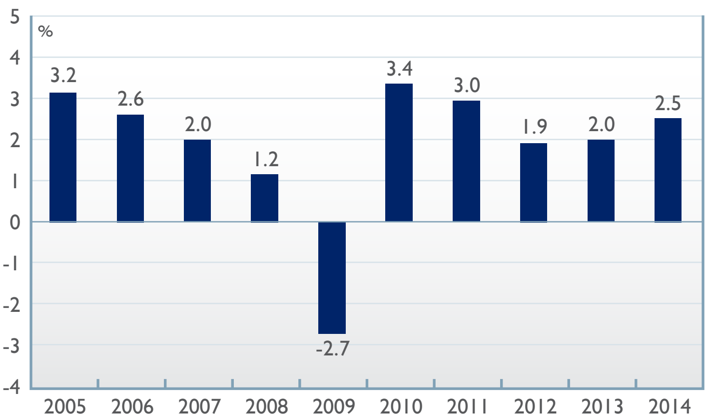
2 As a proportion of private-sector real GDP, which is divided into 17 industries, the largest of which is Real Estate and Rental and Leasing.
3 Investments in the mining and oil and gas extraction sector, which have increased substantially in recent years, have also been extracted from the data so as not to distort the comparison.

The latest indicators show that the impact of the oil price slump was felt very quickly: in January, exports again fell considerably due to the pullback in the value of energy product exports, and the inflation rate dropped again because of lower gasoline prices. Hopefully the negative effects of lower oil prices will fade away in the second quarter of this year.

Real GDP growth accelerated in 2014

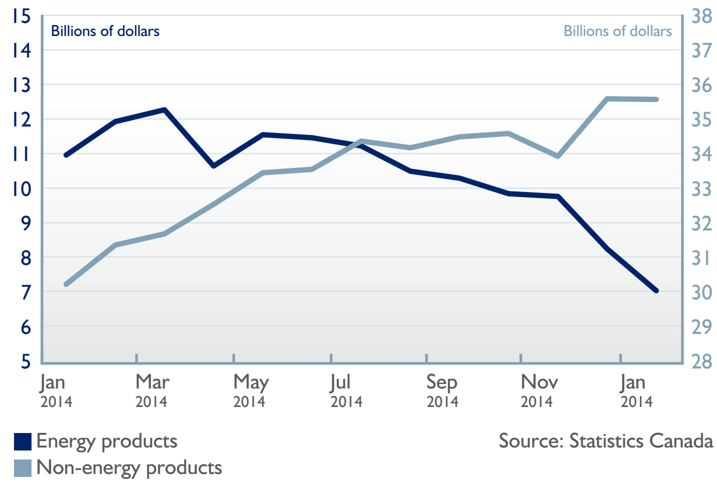
Real GDP grew at an annualized rate of 2.4% in the fourth quarter, compared with the previous quarter; this gives us an annual change of 2.5% for the year 2014 as a whole. This is accelerated growth compared with 2013, when growth came in at 2.0% (graph). Household consumption, residential investment, exports and imports recorded good rates of growth in 2014, higher than those of the previous year. Meanwhile, the results were disappointing for investments in machinery and equipment (which were weak) and investments in non-residential construction, which pulled back. Expenditures and investments by public administrations remained stable in 2014. In 2015, GDP growth should slow to 2.1%, according to forecasters, due to the expected negative impact of the oil price slump on economic activity.

Real GDP
(Annual change, 2005 to 2014)



Source: Statistics Canada

Exports, energy products and non-energy products
(January 2014 to January 2015)



Source: Statistics Canada

The oil price slump drives exports down

Exports fell by 2.8% in January, while imports remained practically unchanged from the previous month. Consequently, the trade balance deteriorated, from $1.2 billion in December to $2.5 billion in January. The pullback in exports is mainly attributable to oil, exports of which recorded a decline of 23.0%, while prices had dropped by 23.2%. Exports of metal products and non metallic mineral products also tumbled in January, but this was on the heels of a sharp increase in the previous month. Contrary to exports of energy products, non-energy exports have continued an upwards trend since July 2014 (graph).

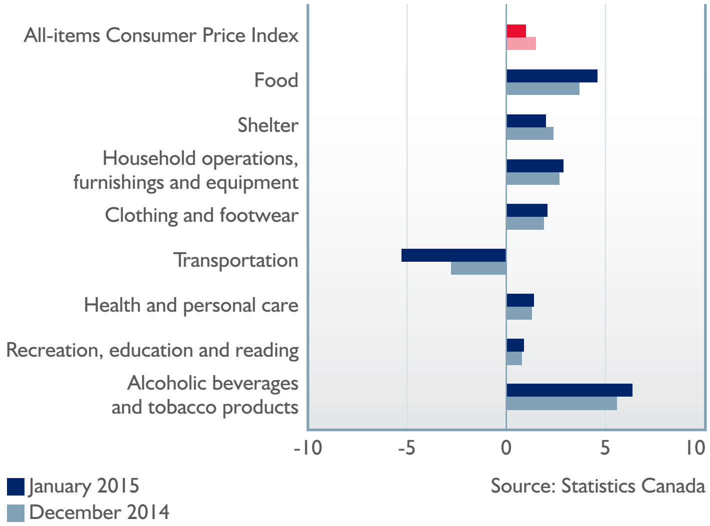
Housing starts rise, but their trend is still downwards

The number of housing starts rose to 187,276 units in January, from 179,637 units in December. This increase is entirely attributable to the multiple-dwelling segment, whose starts in urban centres increased by 12.3% in January compared with the previous month. Meanwhile, starts of single-family homes fell by 3.8% in urban centres. Measured by the six-month moving average, the trend in housing starts is down since September, which is in line with the Canada Mortgage and Housing Corporation's forecasts.

Falling gasoline prices drive the inflation rate down

The inflation rate, measured by the annual growth in the Consumer Price Index, fell for the third straight month, from 1.5% in December to 1.0% in January. This drop is attributable to lower gasoline prices, whose index has plummeted by 34% since last July. According to the Bank of Canada, due to the volatility of oil prices, the annual change in prices could temporarily move into negative territory in the months ahead. This would not be deflation, since the price slump would not be generalized. Apart from the transportation component—which includes gasoline prices—the other components of the Consumer Price Index are up (graph).

All-items CPI and its eight components
(Annual change, December 2014 and January 2015)



Source: Statistics Canada

UNITED STATES

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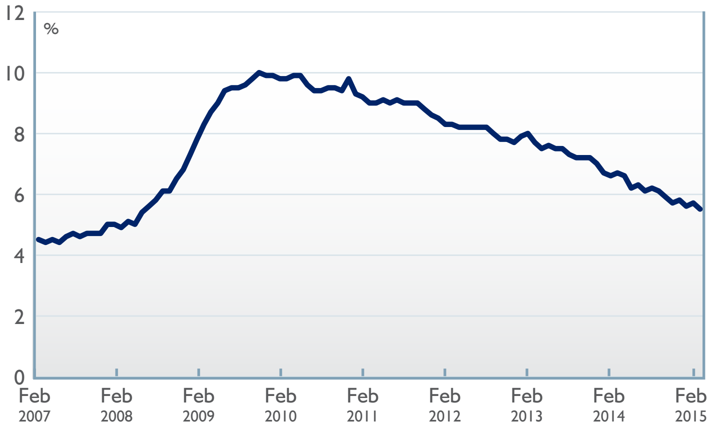
The U.S. economy is firming up, as may be seen from the constant improvement in the labour market. The unemployment rate is slowly but surely getting back to where it was before the recession, and the number of discouraged workers continues to decline. The housing market is also picking up steam, but at a slower pace than in previous years.

Job growth is still solid, and the unemployment rate is dropping

Non-farm employment rose by 295,000 jobs in February after recording average monthly increases of 279,000 over the previous six months. Employment expanded in all the major industry categories except for the mining sector. The unemployment rate dipped by two tenths of a percentage point to reach 5.5%, its lowest level since May 2008 (graph). The number of discouraged workers, i.e. those who have exited the labour market because they are convinced they will not succeed in finding a job, has fallen considerably since 2011, but is still high compared with where it was before the recession (i.e. 732,000 in January versus 423,000, on average, in 2008).

Unemployment rate
(February 2007 to February 2015)



Source: U.S. Bureau of Labor Statistics

Housing starts and existing home sales decline

The number of housing starts was down by 2% in January, compared with the previous month. In the single-family homes segment, starts dropped by 6.7% in January, while they surged by 12.1% in the multiple-dwelling segment. The housing start trend, measured by the six-month moving average, is still positive, but shows that the pace of growth has slowed in recent months. Meanwhile, sales of existing homes declined by 4.9% in January compared with the previous month. Demand is still solid, but there are few new listings, and prices have increased. The inventory of homes is actually 0.5% lower than it was a year ago, and the median price of properties has risen by 6.2% over the past 12 months.

The annual change in the Consumer Price Index dips below zero

In the United States, the annual change in the Consumer Price Index has already slipped below zero. In January, the CPI stood 0.1% below where it was 12 months ago. The relative weight of gasoline in the household consumption basket is similar in Canada and the United States (3.9%), but the plunge in gasoline prices was more severe south of the border (-35.4% versus 26.9%) and therefore had more impact on the American all-items index. Excluding energy, inflation has remained stable at around 1.9% in the United States over the past six months (graph). ■

Consumer Price Index
(Annual change, January 2006 to February 2015)

Source: U.S. Bureau of Labor Statistics

INTEREST RATES

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The key interest rate stays unchanged at 0.75%

On March 4, the Bank of Canada decided to leave the target for the overnight rate unchanged, at 0.75%. Back in January, the central bank lowered the key interest rate by 25 basis points in order to mitigate the apprehended negative impact of falling oil prices on the Canadian economy. The Bank predicts that this impact will make itself felt mainly during the first half of 2015. It notes that monetary conditions have eased since the beginning of the year. In fact, market interest rates have declined since the Bank lowered the key rate, and the Canadian dollar has depreciated against the American currency, which should stimulate exports and investment. ■

OIL PRICE

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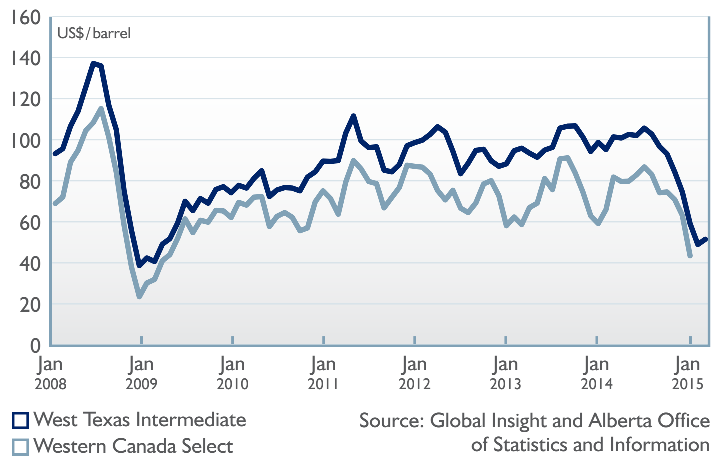
Crude oil prices creep up a little

After a slump of several months, the price of crude oil (as measured by West Texas Intermediate) rose slightly in February (graph). The supply is still overabundant, as may be seen from the state of American oil reserves, which have never been so high; but the announcement of investment cuts by several oil giants (including Chevron, Total, BP and Shell) and the decline in the number of wellbores in recent months herald a reduction in the supply, driving prices up. However, opinions on future supply developments are mixed. Some analysts consider that it will take several months before the decline in investments translates into a tighter supply, and that the supply will continue to expand in the short term. The uncertainty surrounding this issue will likely keep stoking price volatility in the weeks ahead. ■

Price of crude oil
(January 2008 to February 2015)



Source: Global Insight and Alberta Office of Statistics and Information

CANADIAN DOLLAR

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The Canadian dollar continues to depreciate

The Canadian dollar faltered against the American currency in February, losing 3.0% of its value. This brings the scope of its depreciation since last July to 14.1%. The uncertainty surrounding crude oil price trends, and the possibility that the central bank might lower the key interest rate again at the beginning of March—which in the end it did not do—contributed to the depreciation of the Canadian currency.

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

Source: Bank of Canada

SME CONFIDENCE

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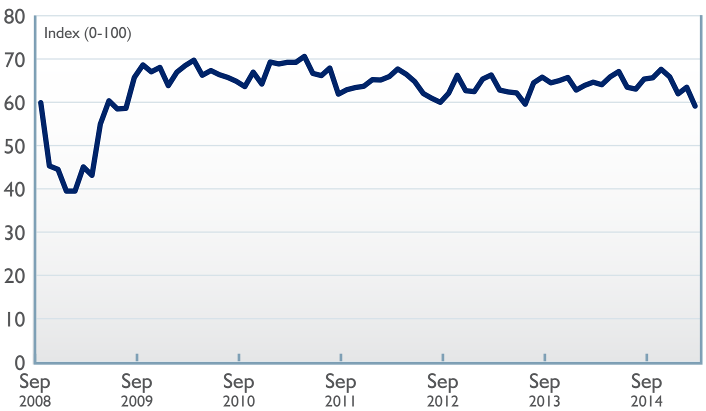
SME owners' confidence drops again

The Canadian Federation of Independent Business's Business Barometer Index tumbled by 4.4 basis points in February, landing at 59.1. This is the first time since June 2013 that the index has fallen below the 60 mark. That said, it is still high compared with where it was during the recession (graph). The apprehended impact of the oil price slump on their business is the main reason for the decline in SME owners' confidence. The Alberta index came in dead last of all the provinces in February (48.2), whereas it was at the top four months ago (74.3). Newfoundland and Labrador, Saskatchewan and Manitoba, provinces whose economies will also be adversely affected by the oil price slump, are posting the lowest confidence levels in the country. At the other end of the scale, SME owners in the Maritimes are increasingly optimistic. Meanwhile, the Ontario and Quebec indexes stand close to the national average.

Business Barometer
(Septembre 2008 to February 2015)



Source: Canadian Federation of Independent Business

BUSINESS CREDIT CONDITIONS

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Bank credit expands sharply

Short-term credit granted to businesses by the chartered banks rose by 1.9% in January compared with the previous month, and long-term credit by 1.1%. Year over year, bank credit has expanded by 11.7 %. The effective interest rate for businesses—a weighted average of various bank interest rates and market interest rates, for new lending to non-financial businesses—has fallen by 25 basis points, to 2.76%, since the Bank of Canada lowered the key interest rate; this is helping to stimulate demand for credit. ■

Business credit from chartered banks

(Annual change, January 2007 to January 2015)

Source: Statistics Canada

KEY INDICATORS—CANADA

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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	2.5	1.0	3.8	3.2	2.4	Dec	0.3	2.1	2.1
Machinery and Equipment Expenditures (% growth)	8.1	1.9	0.7	0.7	-1.1	5.2	9.0	-3.2			-0.6	2.9
Pre-Tax Corporate Profits (% growth)	23.3	-6.7	0.7	11.2	23.4	9.3	8.2	-18.7			-5.4	6.1
Industrial Production (% growth)	4.1	1.4	1.8	3.9	5.4	4.7	1.4	2.6	Dec	0.8	1.2	2.2
Industrial Product Prices (% growth)	6.9	1.1	0.4	2.5	12.7	0.6	-1.2	-6.0	Jan	-0.3	-0.4	2.0
Non-Residential Construction (% growth)	15.9	13.5	5.0	-0.1	-1.3	0.4	0.8	-1.8				
Housing Starts (' 000 units)	193	215	188	189	176	196	199	184	Feb	156	181	178
Personal Expenditures (% growth)	2.2	1.9	2.5	2.8	1.3	4.6	2.6	2.0			2.4	2.0
Consumer Price (% growth)	2.9	1.5	1.0	1.9	3.2	3.3	1.2	0.0	Jan	-0.2	0.8	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	6.7	6.6
SMEs Confidence Index (CFIB)	66.3	63.9	63.9	64.9	64.2	65.5	64.7	65.1	Feb	59.1		
Manufacturers Confidence Index (CFIB)	67.3	66.5	63.8	65.8	65.0	64.3	68.8	64.9	Feb	60.1		

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.