

economic LETTER

JUNE 2012



FUTURE OF THE MANUFACTURING SECTOR

Canada's manufacturing sector has had quite a rough ride over the past decade, but it has not suffered alone. The development of emerging countries, particularly China, has had repercussions on the manufacturing sectors of all the industrialized nations. In fact, this transformation, which is ongoing, is global in scope. The World Economic Forum, in collaboration with the consulting firm Deloitte, asked a team of experts from the manufacturing industry to examine the future of this sector¹. Here we sum up the broad outlines of their report.

Many factors have contributed to the speedy globalization of the manufacturing sector in recent years: changes in east-west geopolitical relations, the advent of digital information, the development of physical and financial infrastructures, the integration of technologies within the sector and the proliferation of free trade agreements. These phenomena have transformed the manufacturing supply chain into a complex global network that allows companies anywhere in the world to take part in design work, in the supply of materials and components and in the manufacture of products destined for customers located anywhere in the world.

The globalization of this sector has led to the creation of value-added jobs in industrialized nations, raised the standard of living in emerging countries and generated many changes in the nature of competition between developing and developed countries, as well as between companies. And the environment is still changing: inflation and wages are rising in emerging countries, turning them into new consumer markets and increasingly less of a source of cheap labour. New issues are appearing at the macroeconomic level: currency volatility, pressure on sovereign debts and the emergence of protectionist policies. These factors could curtail the phenomenon of offshoring.

As for the future of their manufacturing sectors, countries and businesses face the following challenges:

- > **Infrastructure development.** Emerging countries need to develop the necessary infrastructures to allow the manufacturing sector to expand. For developed countries, reinvestment in infrastructures is required to maintain competitiveness. Sovereign debt problems, which restrict the availability of public funds, present a real problem in this respect. It could, however, be solved by public-private partnerships. ▼

Canada

- > **Real GDP growth remains stable**
- > **Employment holds steady**
- > **Trade balance returns to a deficit position**
- > **Housing starts decline, but sales of existing homes advance**

United States

- > **Employment lagging**
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Key interest rate should remain stable until 2013

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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 June 9. Reliance on and use of this information is the reader's responsibility.

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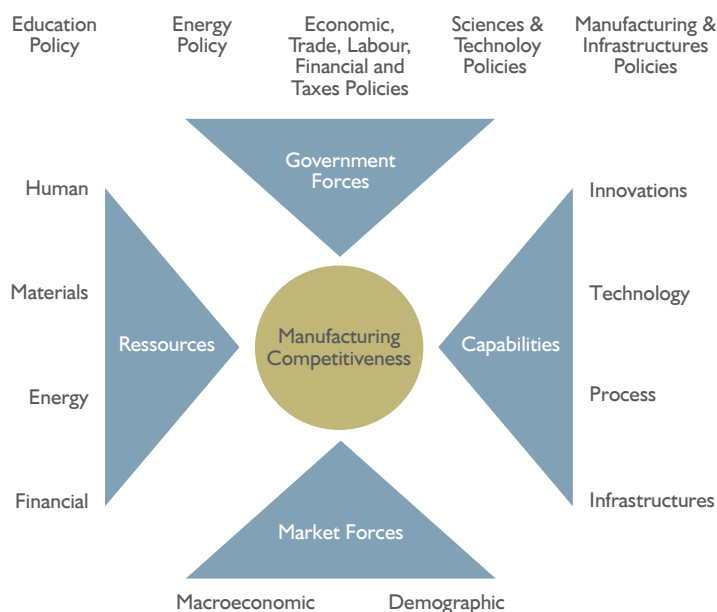
¹ *The Future of Manufacturing: Opportunities to drive economic growth*, report by the World Economic Forum produced in collaboration with Deloitte Touche Tohmatsu Limited, April 2012.

- > Direct foreign investment. Competition between countries to attract foreign investors will be increasingly fierce. It will also be extremely difficult for multinational corporations to decide where to set up shop.
- > Availability of resources. Competition for natural resources (metals, oil, etc.) will intensify. In the short term, countries and businesses can build up stockpiles, but in the longer term, success will depend on the discovery of new deposits or technological advances that will make it possible to use or to develop alternative products.
- > Clean and affordable energy. Expanding populations and the industrialization of emerging countries are generating rising energy costs. At the same time, growing environmental concerns are demanding that countries act responsibly. The manufacturing sector will have to find manufacturing methods, from design to production, including operations and logistics, that use energy cleanly and efficiently.
- > Ability to innovate. The ability to innovate—and to do it quickly—will make the difference for successful countries and businesses.
- > Development of human capital. Innovation goes hand in hand with a labour force that is able to do it. Talented human capital will be key to the success of countries and businesses. It is estimated that, around the world, 10 million jobs for qualified workers are currently going unfilled in the manufacturing sector.
- > Government policy. The use of government policies to foster economic development will intensify; this will stimulate competition between countries as far as effective policies are

concerned, and promote collaboration between government decision-makers and companies to create win-win solutions.

The diagram below illustrates the environment and the major trends on which the competitiveness of the manufacturing sector will depend in the future, including market forces, both macroeconomic and demographic, as well as the resources and skills for which countries and companies will be competing. There is no doubt that the manufacturing sector has a future, but it will be rosier for those countries and businesses that are most successful in meeting these multiple challenges. ■

Global Manufacturing Competitiveness Framework



CANADA

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A good portion of real GDP growth in the first quarter came from robust residential construction. But housing starts declined in May, and the CMHC forecasts that their pace of growth will continue to slow between now and the end of the year. Therefore, some other components of the GDP will have to step into the breach to ensure economic growth in the upcoming quarters.

Real GDP growth remains stable

Real GDP growth came in at 1.9% in the first quarter of 2012, exactly the same as in the last quarter of 2011. But there are differences in the sources of growth compared with the previous quarter, particularly in consumption, where growth was weaker (0.9% versus 2.8%), and investment in residential construction, which accelerated significantly (12.3% versus 3.0%). Exports rose at a much slower pace ▼

Real GDP Growth (quarterly change at annual rate)



(2.5% versus 7.2%), while imports grew faster (4.4% versus 2.3%). The variation in the other components remained virtually unchanged, as shown by the graph. Investment in business inventories also contributed to growth in the first quarter. All in all, the first-quarter results are pretty much in line with expectations. We remind readers that the forecasters are calling for 2.1% growth in 2012.

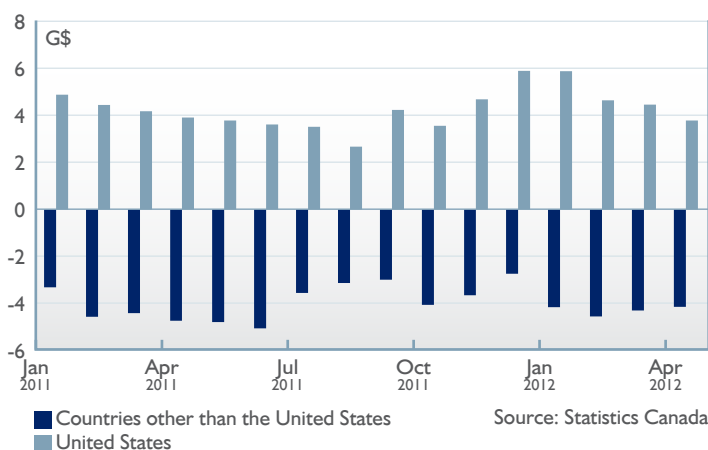
Employment holds steady

After two months of strong growth, employment was virtually static in May compared with the previous month, recording a mere 7,700 new jobs, while the unemployment rate remained stable at 7.3%. The sectors with the largest gains were manufacturing, educational services and commerce, while construction, information, culture and recreation posted the biggest losses. In regional terms, employment expanded in New Brunswick, Quebec and Alberta, while it declined in the other provinces.

Trade balance returns to a deficit position

Exports fell by 1.2% in April compared with the previous month, while imports ticked up by 0.1%, shifting the trade balance from a \$152 million surplus in March to a \$367 million

Trade Balance

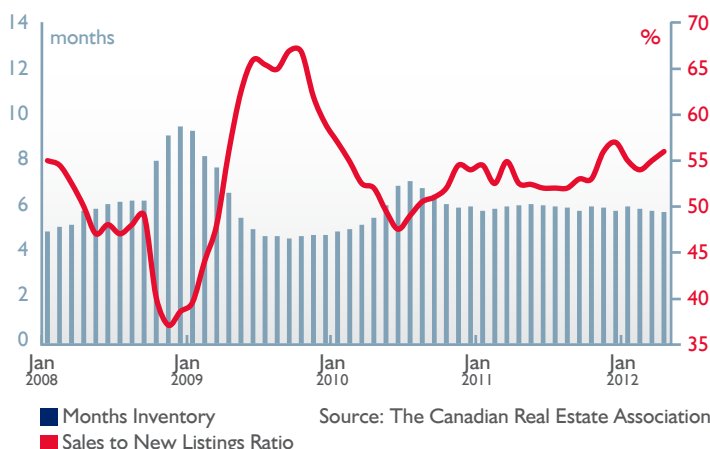


deficit in April. Exports of industrial goods and machinery and equipment suffered the largest contractions. Exports of crude oil lost ground for the third straight month due to lower prices. Imports of automotive products increased, while those of energy products declined. The trade surplus with the United States shrank, while the trade deficit with countries other than the United States narrowed slightly (see graph)

Housing starts decline, but sales of existing homes advance

Housing starts dropped from 243,800 units in April to 211,400 units in May, a level that is more in keeping with the average of the past six months, according to the Canada Mortgage and Housing Corporation, which predicts that the pace of housing starts is likely to head downward for the rest of the year. Meanwhile, sales of existing homes rose by 0.8% from March to April, and the average price posted a 0.9% increase in April compared with the previous year. According to the Canadian Real Estate Association, the resale market is generally balanced, as shown by the ratio of sales to new listings, which has remained fairly stable since the end of 2010 (see graph). ■

Residential Market Balance



★ UNITED STATES

The slowdown in job creation in recent months is reviving concerns about the solidity of the economic recovery. Both employment data and housing starts and resales show that the housing sector has not yet managed to get back on track. There is reason to fear that the economy will remain fragile as long as this sector is not really out of the woods.

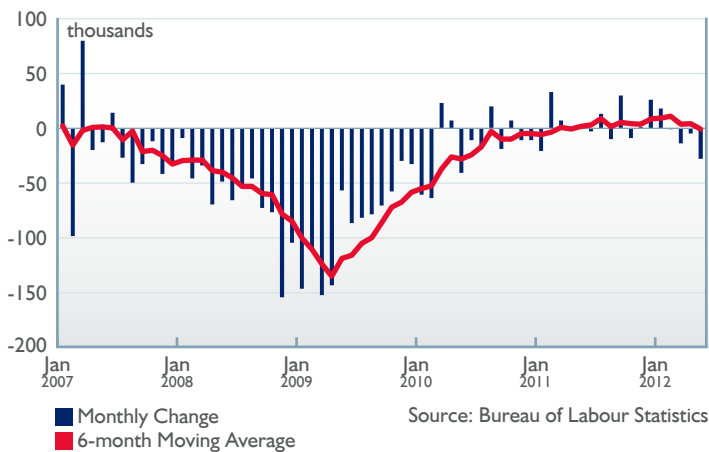
Employment lagging

Only 69,000 jobs were created in May, and April's upturn in employment has been revised downward, from 115,000 to 77,000. The unemployment rate edged up by 0.1%, to 8.2%.

Job growth has clearly slowed since February. Gains in the healthcare, transportation and storage and wholesale sectors offset the loss of 28,000 jobs in the construction industry in May. That sector is having enormous trouble picking up steam, having failed to recover the jobs lost during the recession and the months that followed it. Employment in that sector has stabilized since the beginning of 2011, but has not gained strength, as shown by the graph. Overall, the employment data are not encouraging; they give reason to believe that the economic recovery is still very fragile. ▼

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Monthly Change in Employment; Construction



Housing market still sluggish

Housing starts rose by 2.6% in April compared with March, after a decline of the same scope in the previous month. Thus they are back exactly where they stood in February. Starts of single family homes have been trading water since the start of the year, while multiple-unit projects are continuing to rise, but extremely slowly. In the real estate market, sales of existing homes have been riding a roller coaster since the beginning of 2012, but are nevertheless following the upward trend that began around a year ago. Overall, the housing market has stabilized, but has yet to show much vitality.

Businesses and consumers somewhat less confident

The Institute for Supply Management's Purchasing Managers' Index for the manufacturing sector fell by 1.3% in May, standing at 53.5%. The New Orders Index continued its upward trend, but the Production Index lost ground. Having said that, at 53.5%, the ISM still indicates growth, not only in the manufacturing sector but in the economy in general, as it is well above the threshold of 42.6% which reflects growth (graph). Meanwhile, after a slight dip in April, the Conference Board's Consumer Confidence Index dropped again in May, to 64.9. American consumers are less optimistic about the business climate and employment, and are more pessimistic about short-term economic outlooks. On the other hand, they are more confident about their income prospects ■

Purchasing Manager Index – Manufacturing Sector



INTEREST RATES

Bank of Canada holds key interest rate steady

On June 5, the central bank decided to again hold its key interest rate steady, at 1.0%. The Bank of Canada recognizes that global economic outlooks have recently deteriorated, and downside risks are materializing more and more. It notes that the Canadian economy is still managing to show momentum, but is concerned about stronger-than-expected activity in the housing market and the growing household debt burden in an

environment of modest income growth. That said, the central bank repeated that it will eventually have to reduce the current monetary policy stimulus—in other words, raise the key interest rate—if the excess supply in the Canadian economy continues to be absorbed. However, the majority of forecasters believe the central bank will not move in that direction until 2013. ■

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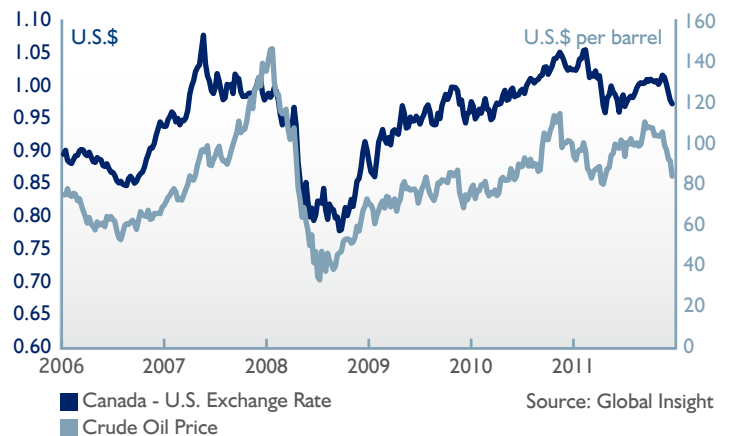
OIL AND THE LOONIE

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Significant drop in the price of oil drives the loonie down

The resurgence of sovereign debt problems in Europe, particularly Spain, which many analysts believe is unable to recapitalize its banks and honour its debts, and the absence of a firm commitment by Europe to resolve the crisis, have sent the price of crude oil plunging in recent weeks. The risk of a more severe-than-anticipated slowdown of the global economy has driven down not only the price of oil, but also the price of many other commodities, and this has led to a significant depreciation of the Canadian dollar. ■

Crude Oil Price and Canada-U.S. Exchange Rate



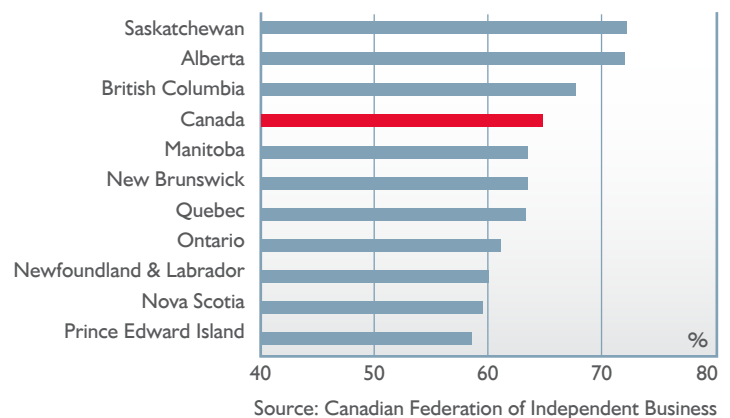
SME CONFIDENCE

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SMEs' confidence slips

The Canadian Federation of Independent Business's Business Barometer Index lost ground in May for the second straight month, coming in at 66.4%, its lowest point in six months. Worries sparked by the aggravation of the sovereign debt crisis in Europe no doubt contributed to the deterioration in small and medium-sized business owners' confidence. Looking at the regions, entrepreneurs are still far more confident out West than in the East, as shown by the graph below. Ontario's figure plunged in May and now stands below the national average. From a sectorial perspective, confidence does not differ much from one sector to another, with the exception of the natural resources sector and health services, where optimism is higher. One fact worth noting is that, despite a decline in confidence, business hiring plans improved in May. ■

Business Barometer, by province (May 2012)





BUSINESS CREDIT CONDITIONS

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Banks increase business credit

Short-term business credit granted by the chartered banks soared by 27.3% in April compared with the previous month, while long-term credit surged by 11.2%. Looking at a one-year horizon, overall growth in commercial lending by the chartered banks stood at 9.1% in April (graph). ■

Business Credit from Chartered Banks
(year-over-year change)



Source: Bank of Canada



KEY INDICATORS — CANADA

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Key indicators — Canada	Historical				2012				Latest	Forecasts	
	2008	2009	2010	2011	Q1	Q2	Q3	Q4		2012	2013
Real GDP (% growth)	0.7	-2.8	3.2	2.4	1.9				Mar	0.1	2.1
Machinery and Equipment Expenditures (% growth)	-0.5	-19.5	11.8	12.5	4.0						5.1
Pre-Tax Corporate Profits (% growth)	11.0	-33.1	21.2	15.4	-10.0						7.7
Industrial Production (% growth)	-3.1	-9.5	4.9	3.5	-1.3				Mar	-0.4	2.5
Industrial Product Prices (% growth)	4.3	-3.5	1.0	4.6	0.6				Apr	0.0	2.4
Non-Residential Construction (% growth)	7.9	-22.2	2.8	13.7	5.7						
Housing Starts (' 000 units)	212	148	191	193	207				May	211	192
Personal Expenditures (% growth)	3.0	0.4	3.3	2.4	0.9						2.1
Consumer Price (% growth)	2.4	0.3	1.8	2.9	2.1				Apr	0.4	2.1
Employment (% growth)	1.7	-1.6	1.4	1.5	0.9				May	0.0	
Unemployment Rate (%)	6.1	8.3	8.0	7.5	7.4				May	7.3	7.3
SMEs Confidence Index (CFIB)	56.1	57.7	66.7	66.4	66.3				May	64.8	
Manufacturers Confidence Index (CFIB)	52.7	56.0	68.6	67.2	69.0				May	66.3	

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

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