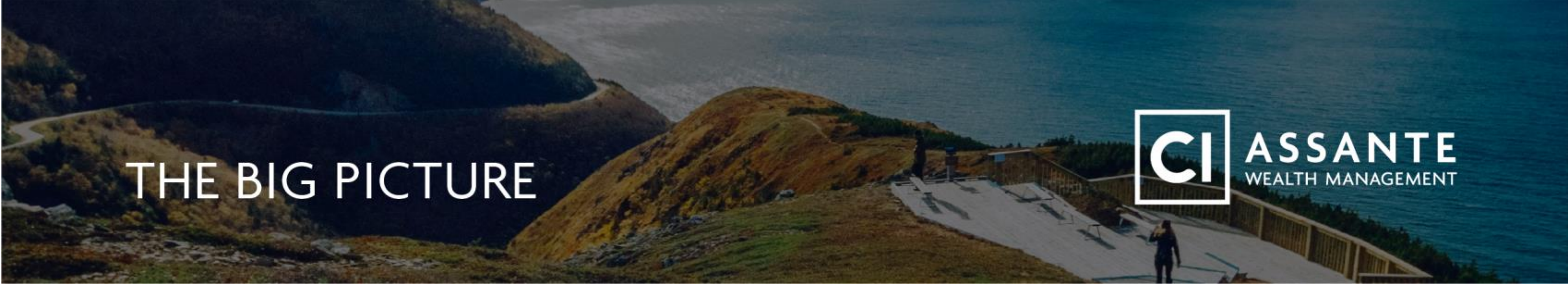


# Poor productivity leaves Canada behind

November 2023

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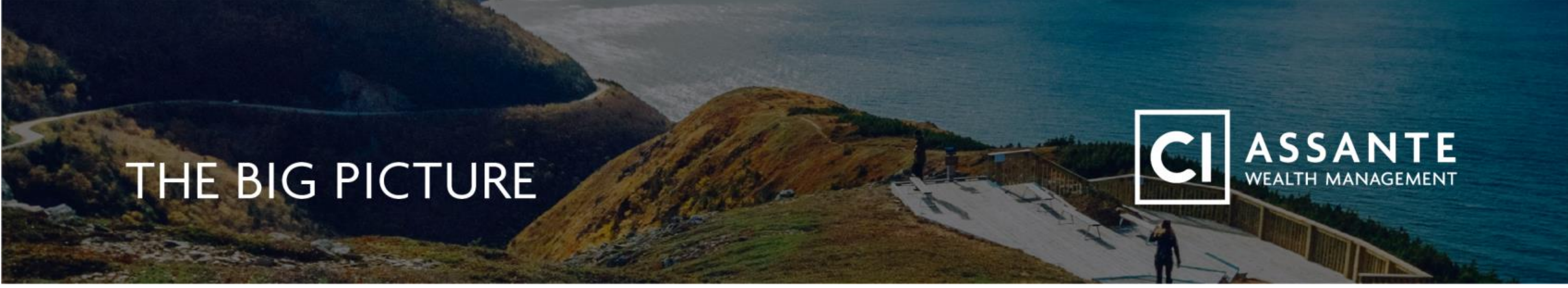
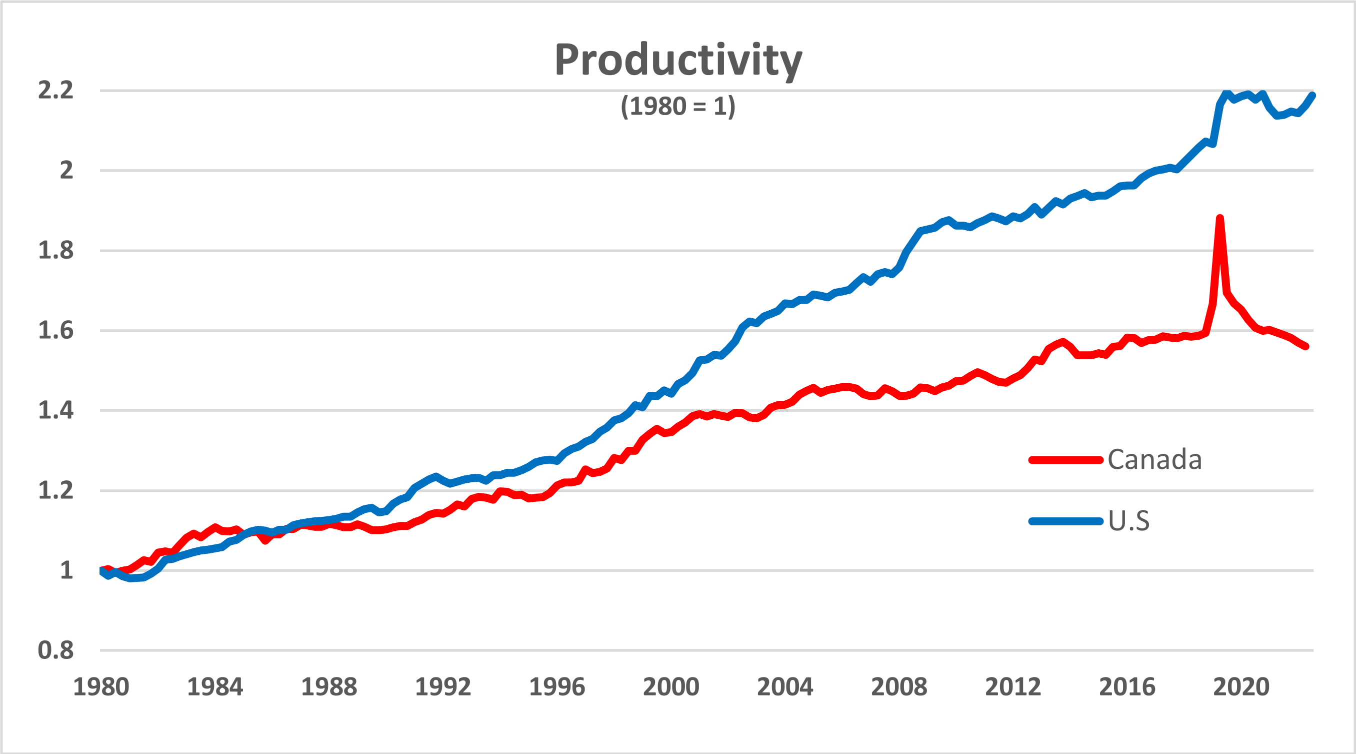
In the wake of the COVID-19 pandemic, the world's economies have seen a number of growing concerns. The acceleration of inflationary pressures has led to dramatic increases in interest rates. The dampening effect of these higher rates has raised the spectre of a possible recessionary period. Unfortunately, on the domestic front, weak growth in productivity has heightened these concerns. In a speech delivered to the Canadian Chamber of Commerce Canada 360 Summit in 2022, Bank of Canada Governor Tiff Macklem spoke specifically about this issue: "Productivity growth is vital to non-inflationary growth and rising standards of living. At a time when inflation is already well above our target, this is more vital than ever."[1] Unfortunately, Statistics Canada reported that labour productivity of Canadian businesses contracted 0.6% in the second quarter of 2023. As can be seen in the accompanying graph, following the pandemic-induced data anomaly, this is now the fifth consecutive quarterly decline in labour productivity. In fact, there have been 11 declines over the last 13 quarters and productivity is at its lowest level since the third quarter of 2015. Relative to the U.S., Canada's performance has been even more disappointing. A "home country bias" is normal for most long-term investors, but Canada's relative weakness on a number of fronts suggests that geographical diversification when investing is now more important than ever.

[1] **Bank of Canada Governor Tiff Macklem Canadian Chamber of Commerce Canada 360 Summit – February 9, 2022.**




Source: Statistics Canada; U.S. Bureau of Labor Statistics

### Business Investment

Central bankers and economists have been worried about Canada's deteriorating productivity trend for many years. With the clear divergence of economic activity between Canada and the U.S., recently, these concerns have broadened. Productivity measures economic output per hour worked. If productivity were stable, the growth of Canada's population and the commensurate increase in the number of workers would raise the demand for goods and services that accompanies that population growth. This would be expected to boost growth in the broader economy. This is clearly not the case at this juncture, as economic growth has been absent since the beginning of 2023.

The drop in Canadian productivity reflects weak business investment in machinery and technology, which would help workers do their jobs more efficiently. Investors look to place their capital in profitable businesses. Not surprisingly, there is a strong link between capital investment, productivity and profitability. "Historical data for the peer countries reveal a strong positive relationship between investment in machinery and equipment (M&E) and labour productivity."[2] Business investment in Canada saw dramatic swings in 2020. The onset of the pandemic early in the year left little appetite for the business risks associated with

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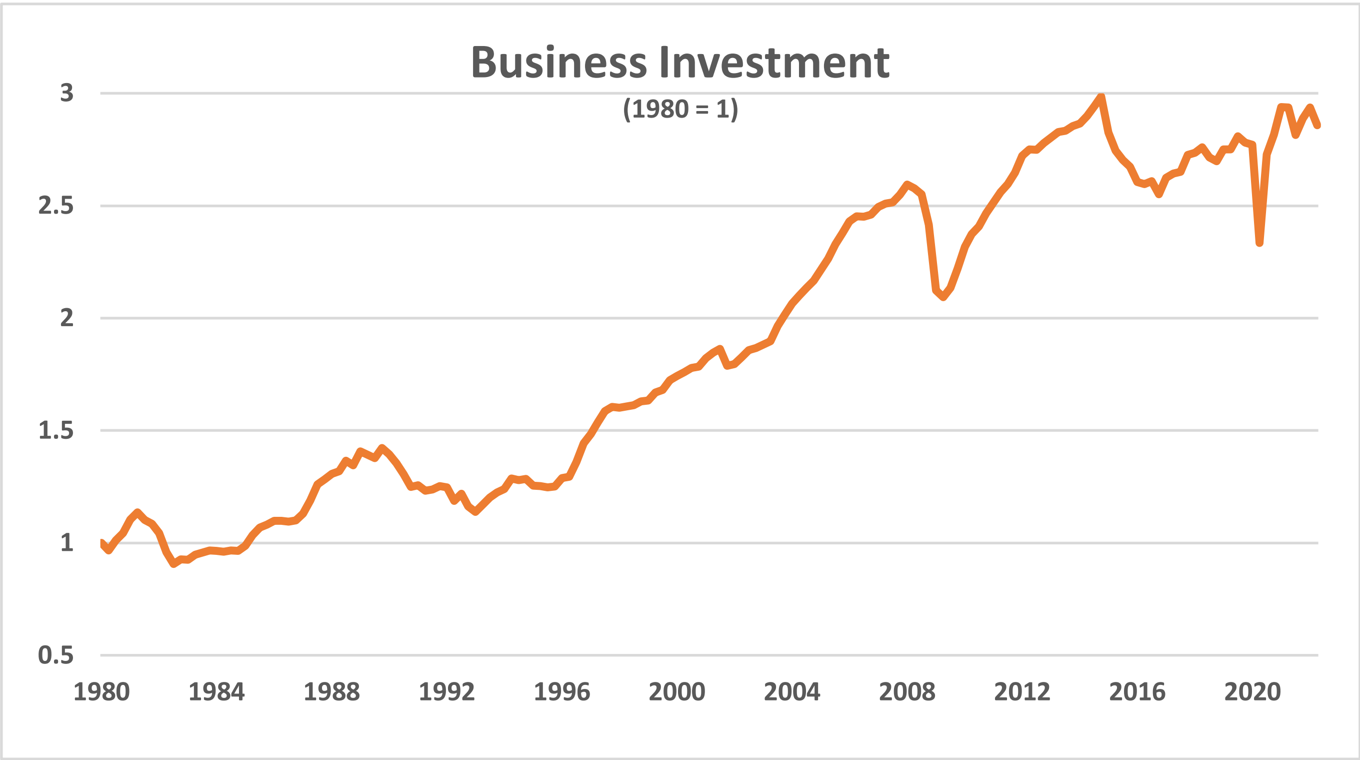
[2] ***Investment and Productivity.*** **The Conference Board of Canada. ND. Retrieved October 17, 2023, from https://www.conferenceboard.ca/hcp/investprod-aspx/**

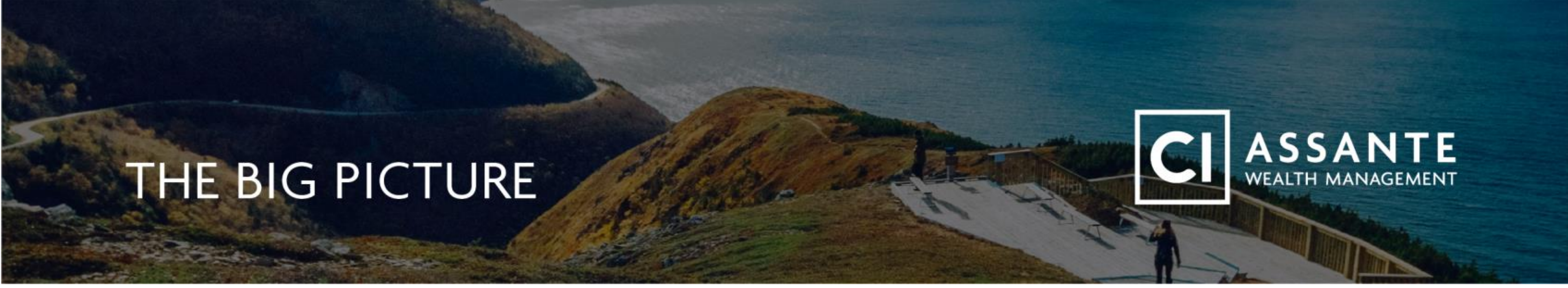
investing in new plants and equipment. Following a historic 49.6% (annualized) drop in business investment in the second quarter of 2020, investment improved modestly over the balance of the year. However, more recently, investment has declined with six of the past nine quarters seeing negative results. Stepping back from the pandemic timeframe, the data show that weakness in business investment has prevailed for an extended period. As can be seen in the following chart, updated figures from Statistics Canada revealed that business investment peaked in the final quarter of 2014 and has had no subsequent success in claiming a new high.[3]

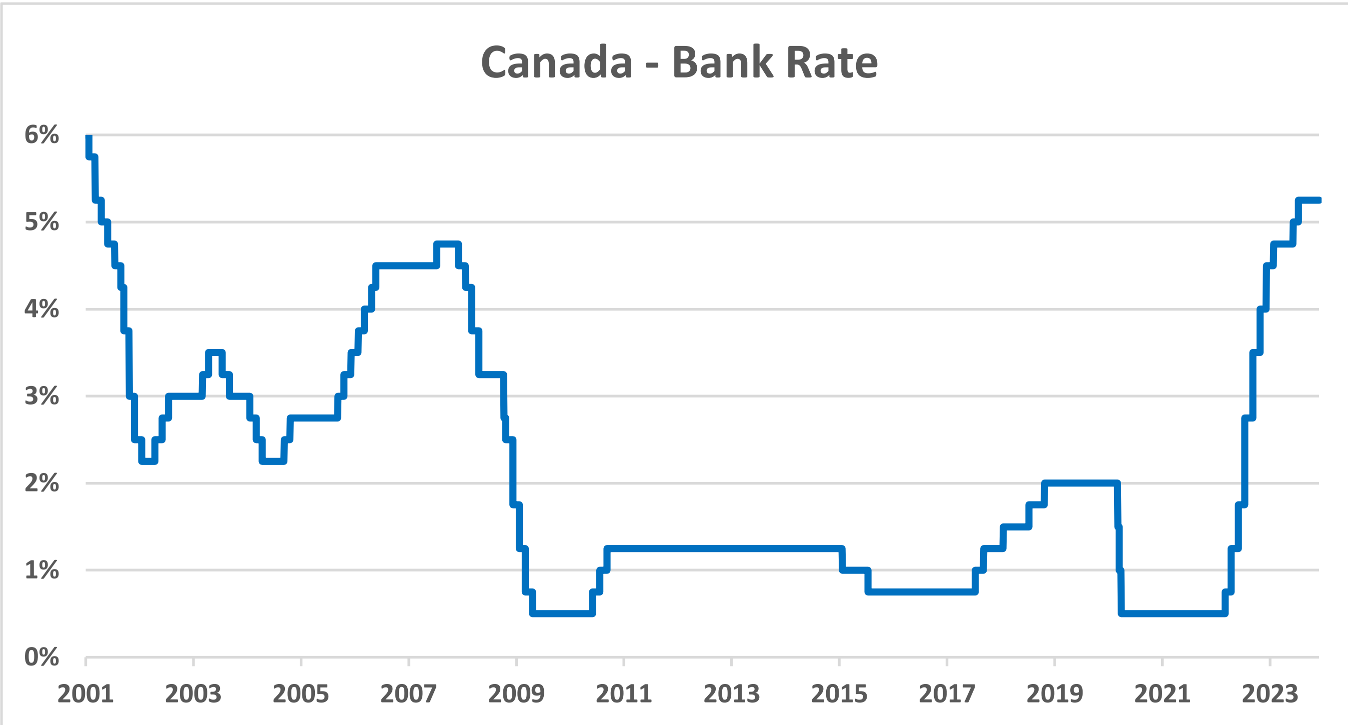



Source: Statistics Canada

Not surprisingly, business investment is also being influenced by higher borrowing costs. Higher interest rates push the break-even points of new business projects higher. Any of these projects that cannot cover the increased borrowing costs will be moved to the back burner, until such time as they can proceed. As can be seen in the graph below, the Bank of Canada has held administered interest rates steady since its July policy announcement. The range for overnight borrowing was then set at 5.00% to 5.25% with the official Bank Rate at 5.25%. The cumulative 475 basis points of tightening that began in March 2022 is the largest set of interest rate increases since November 1987 to May 1990, when the Bank Rate was moved from 8.09% to 14.05% (596 basis points). The last time the Bank Rate stood at 5.25% was April 16, 2001. How long these higher interest rates persist will depend upon a number of factors.

[3] ***Gross domestic product, income and expenditure, second quarter 2023.*** **Statistics Canada. September 1, 2023. Retrieved October 17, 2023, from https://www150.statcan.gc.ca/n1/daily-quotidien/230901/dq230901a-eng.htm**

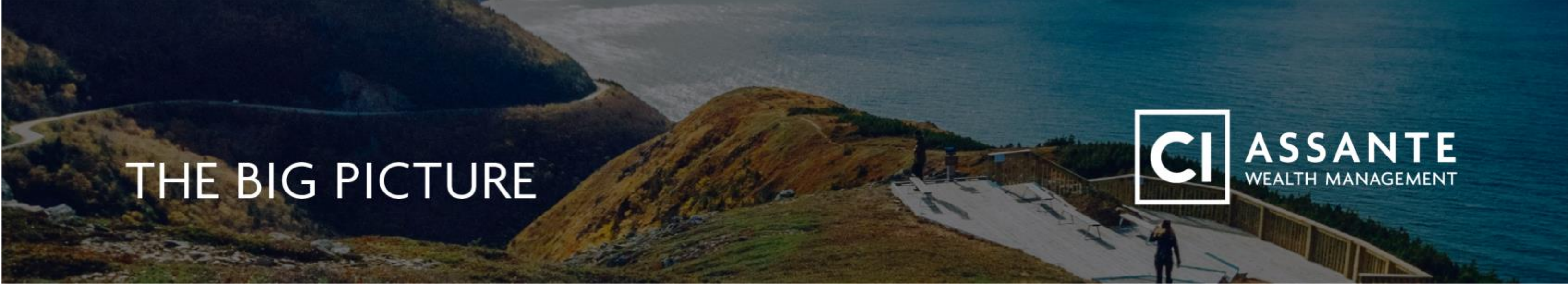




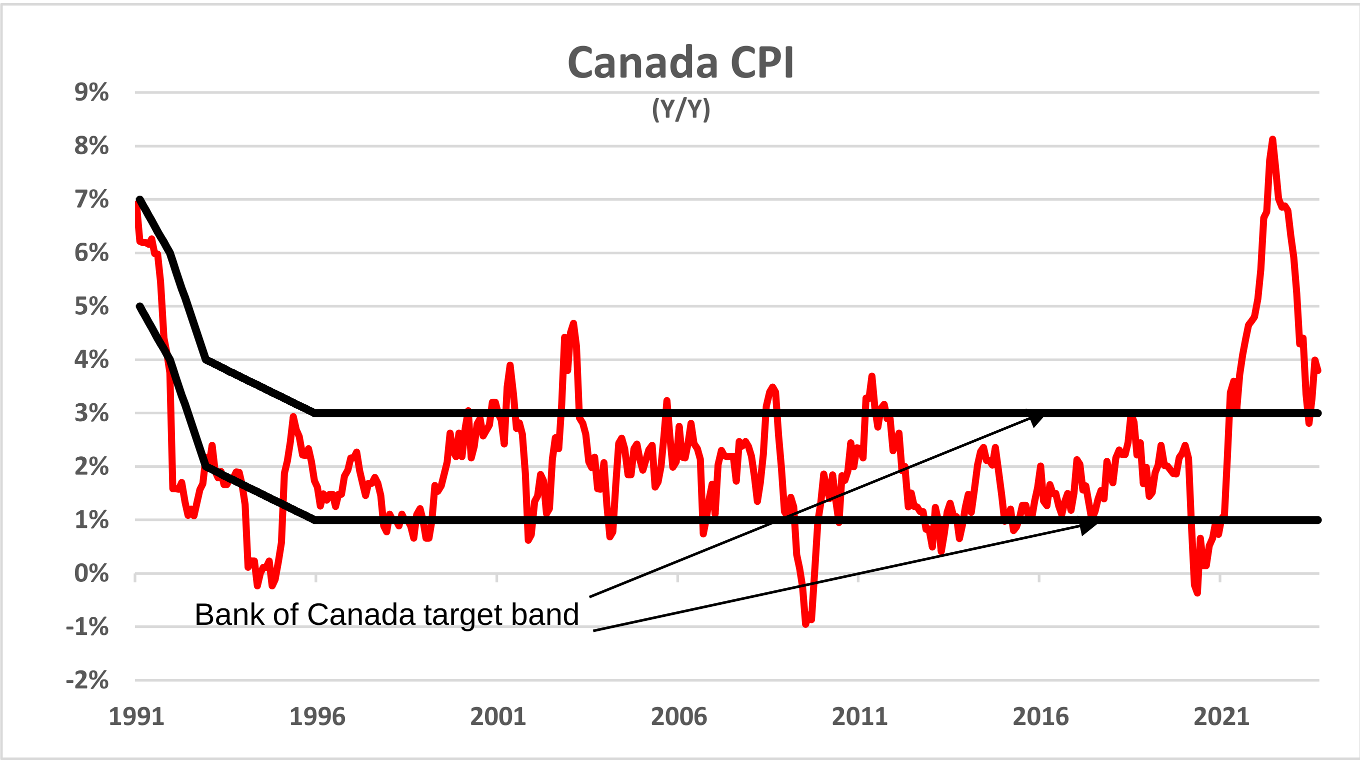

Source: Bank of Canada

Even if the pause in raising rates in the short end of the yield curve (overnight borrowing rates) lasts, the Bank is left with a policy dilemma. After resorting to Quantitative Easing (QE) during the pandemic, this program must now be reversed. According to the Bank, “under QE, a central bank buys government bonds. Buying government bonds raises their price and lowers their return—the rate of interest they pay to bondholders. This rate of return is also known as the bond’s yield.” The Bank did not engage in QE during the 2008/09 financial crisis. QE is now being reversed by Quantitative Tightening (QT), which means selling these same government bonds into the market. However, this is happening at the same time that the government itself is tapping those markets by issuing *new* bonds to borrow to fund the deficit. This ”crowding” of the markets is expected to put additional upward pressure on interest rates in the maturities where those bonds are issued. Further, this process essentially forces the Bank to sell its assets at a loss – selling low after buying high.

Importantly, the October 25 release of the Bank’s latest Monetary Policy Report disclosed that slower economic growth and higher inflation are anticipated for 2023 and 2024. The Bank now forecasts GDP growth of 1.2% for 2023 (from 1.8% in the July forecast) and 0.9% for 2024 (from 1.2% in the July forecast). Similarly, the CPI forecasts are now: 3.9% for 2023 (3.7%) and 3.0% for 2024 (2.5%). “CPI inflation is expected to average about 3½% through the middle of next year before gradually easing to 2% in 2025. Inflation returns to target about the same time as in the July projection, but the near-term path is higher because of energy prices and ongoing persistence in core inflation.” The latest figures from Statistics Canada revealed that its consumer price index rose 0.2% (seasonally adjusted) in September. On a year-over-year basis, the CPI was up 3.8%. This was down from the 8.1% peak figure recorded in June 2022, which was the fastest pace since January 1983 (8.2%). However, as can be seen in the accompanying graph, inflation has strayed far from the Bank of Canada’s target band. Forecasters now suggest that a return to 4% inflation is likely to occur by year-end.








Source: Statistics Canada; Bank of Canada

## Other Issues

Given the economic uncertainties surrounding the COVID-19 pandemic, a boost in government spending was employed in an effort to offset the shuttering of much of the economy. However, “crowding out” of private sector activity became a concern once the economy began to reopen. As can be seen in the graph below, government spending surged during the pandemic. Government spending, that had fallen from 53.3% of GDP in 1992 to 38.4% in 2014, broke back to 53.0% of GDP in 2020. Not surprisingly, the addition of some 100,000 federal civil servants over the past eight years has come with a cost.[4] The scale of government activity has, historically, proven difficult to rein in. Regulatory uncertainty is also one of the reasons why companies are reluctant to invest. While focused on a single sector, energy stocks account for about 13.5% of Canada’s primary stock index (TSX). Uncertainty in energy policy appears to be limiting business investment opportunities. The CEO of Suncor Energy, one of Canada's largest oil producers, told a parliamentary committee that the country’s energy policy was scaring away capital investment in the sector. The comments were delivered after Canada's Supreme Court ruled that a key federal law assessing the environmental impact of major projects, like oil sands plants and coal mines, was largely unconstitutional. A continuation of

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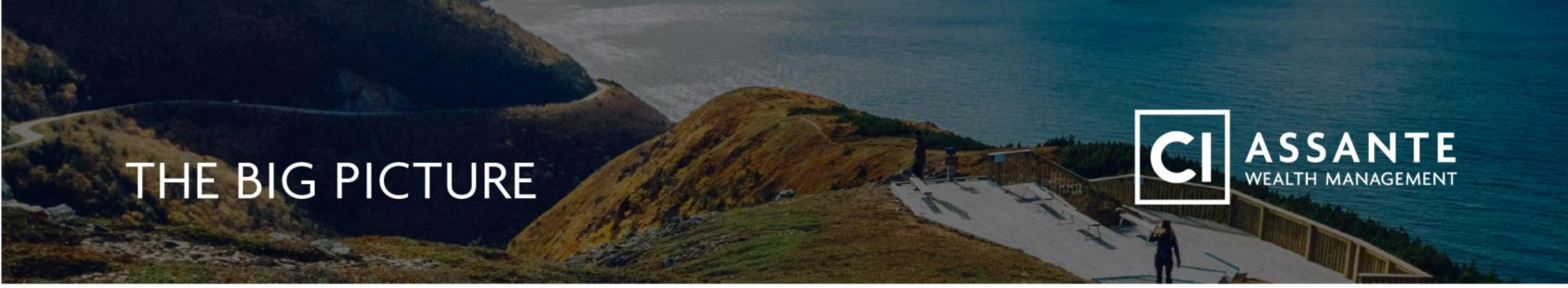
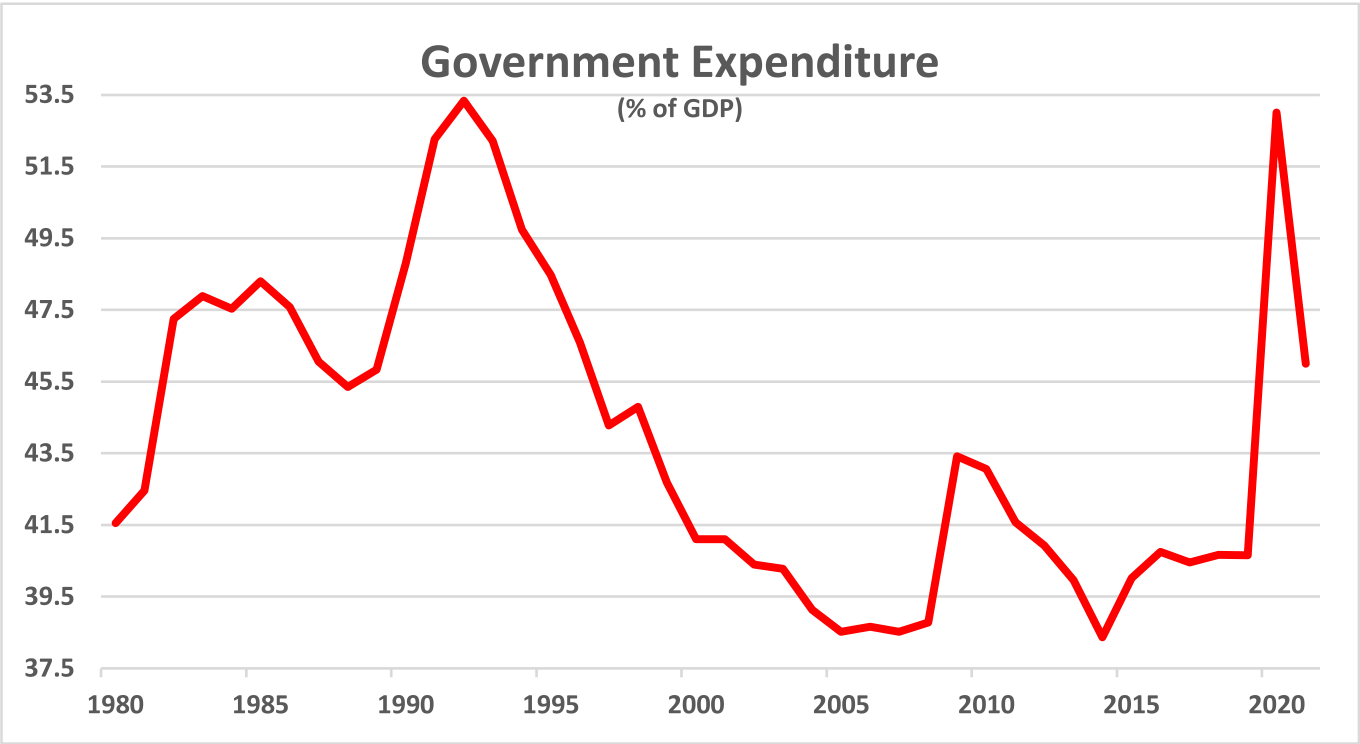
[4] ***Population of the Federal Public Service.*** **Statistics Canada. ND. Retrieved October 17, 2023, from https://www.canada.ca/en/treasury-board-secretariat/services/innovation/human-resources-statistics/population-federal-public-service.html**





Canada's weak business investment environment, in this and other sectors, will serve to limit any potential improvement in productivity and profitability.




Source: International Monetary Fund

**Bureaucratic red tape can also limit the scope of investment opportunities. Data from the Business Development Bank of Canada (BDC) show that roughly one of every 1,000 Canadians is starting a business today. This compares poorly to the three out of every 1,000 Canadians 20 years ago. The trend is viewed as "alarming" since entrepreneurship has an outsized influence on fueling economic growth and innovating new products and technologies. "Entrepreneurs are the backbone of Canada's economy: They spearhead innovations. They're responsible for virtually all net new job creation. They drive growth and transformation. Yet fewer people are venturing into business ownership each year. And nearly one-third of those who do will close their business within five years." Small business owners indicate that they now face a "more complex business environment."[5] In a recent article in the Financial Post, author and entrepreneur Frank Stronach questioned "Why is the business environment more complex today than it was 20 or even 50 years ago? I would argue that it's mainly because of government red tape and regulations, which continually grow year after year and weigh down small businesses. The other key factor is that**

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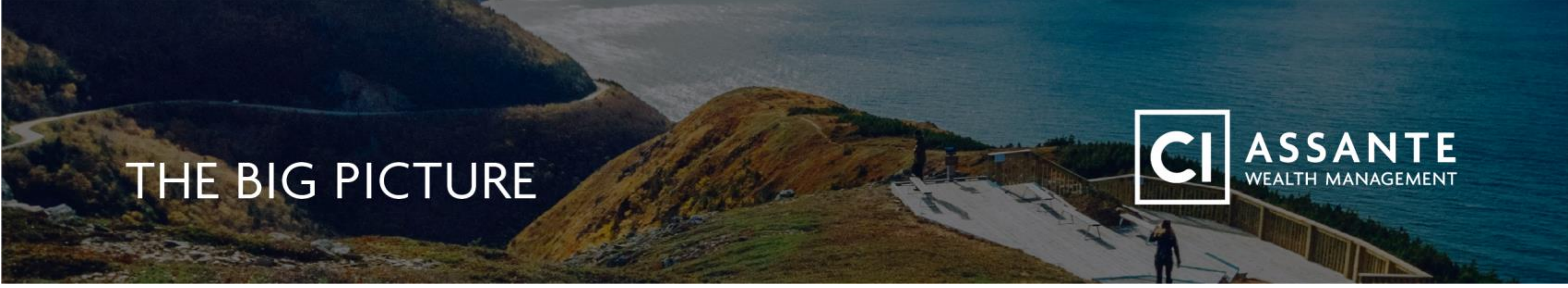
[5] ***Nearly half as many people are launching businesses as 20 years ago*. Business Development Bank of Canada. October 16, 2023. Retrieved October 24, 2023, from https://www.bdc.ca/en/about/mediaroom/news-releases/nearly-half-as-many-people-are-launching-businesses-as-20-years-ago**




we tax small businesses to death during the critical period of time when they need as much cash as possible to get up and running."[6]

## Standard of Living

For most, the expectation of a rising standard of living has long been a part of Canada's legacy. This is now in doubt for the current generation. The Business Council of British Columbia recently studied Canada's standard of living and their research provided some unwelcome news. They found that Canada was "one of the few advanced countries" whose citizens have a lower standard of living than they did before the COVID-19 pandemic.[7] Since 2015, "Canadian real GDP per capita has grown at a meagre rate of only plus 0.4 per cent annually, paling in comparison to the advanced economy average of plus 1.4 per cent." The OECD projected that between now and 2060, Canada would see per capita GDP growth of just 0.7 per cent annually, making it the single worst performing economy of all 38 OECD members. In 1981, Canada ranked sixth in the world for GDP per capita, behind only Switzerland, the United States, Norway, Denmark and Netherlands. By 2021, all of those countries remained in the top five, but Canada had plunged to a distant 12th place. The average Canadian in 1981 enjoyed a standard of living that was $3,000 higher than the rest of the Western developed world. "Forty years later, Canada was $5,000 below that same average." It remains to be seen if Canada will experience a recession in the near term. If so, Canada's poor productivity will limit the speed and scope of the recovery, as the deficits rung up during the recent growth cycle leave little dry powder for the government.

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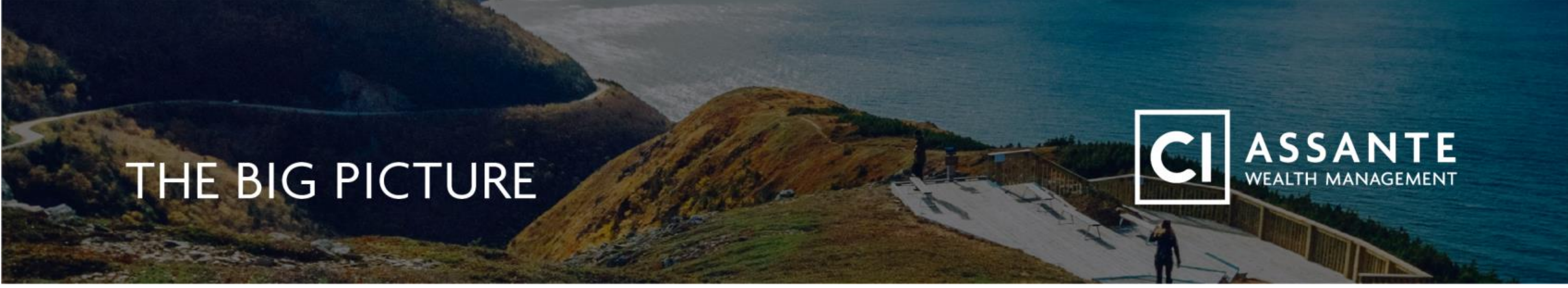
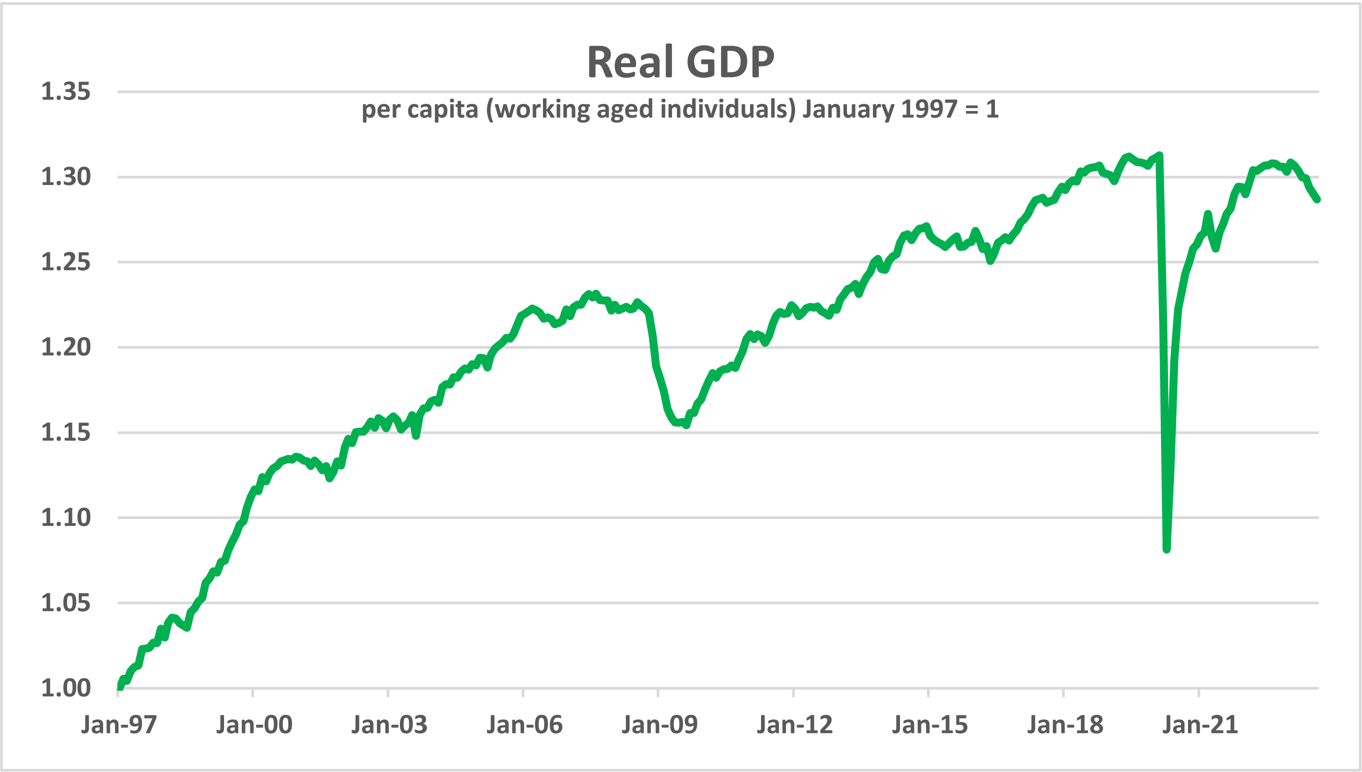
[6] ***Frank Stronach: Thank red tape for making Canadian entrepreneurs a dying breed*. Financial Post. October 31, 2023. Retrieved October 24, 2023, from https://nationalpost.com/opinion/frank-stronach-thank-red-tape-for-making-canadian-entrepreneurs-a-dying-breed**

[7] ***Canada is not generating the income needed to regain our pre-pandemic living standards*. Business Council of British Columbia. June 26, 2023. Retrieved October 24, 2023, from https://bcbc.com/insight/canada-is-not-generating-the-income-needed-to-regain-our-pre-pandemic-living-standards/**

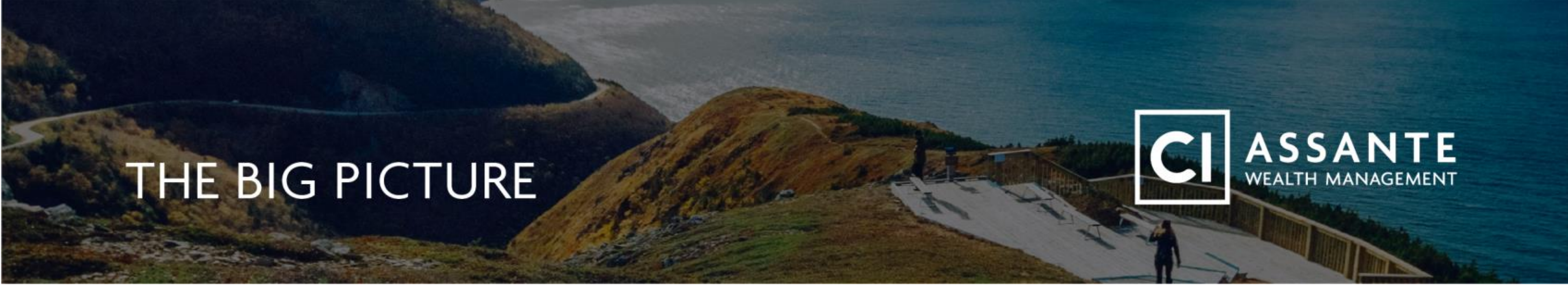



Source: Statistics Canada

## CONCLUSIONS

- The Canadian economy may not be able to avoid a recession in the near term. While business cycles are a normal part of the economic life of a country, poor domestic productivity can be expected to hamper a return to more robust growth.
- The Bank of Canada and other central banks that have been using "easy" monetary policy to support the economy are now confronted with a loss of credibility as they face persistent "sticky" inflationary pressures. Higher interest rates and Quantitative Tightening can be expected to persist for some time.
- Having a professional advisor can help address personal biases and put things into perspective. A well-diversified portfolio, with regular rebalancing, is the best way to preserve and grow wealth.

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