



## ECONOMICS

# Waiting for the Export Multiplier

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Canada's manufacturing exports have responded better than advertised to global demand and currency movements over the past few years. Export volumes kept up with (slowing) foreign demand, with dollar sensitive sectors leading the way. The real disconnect is the inability of manufacturers to translate these export gains into GDP and employment gains.

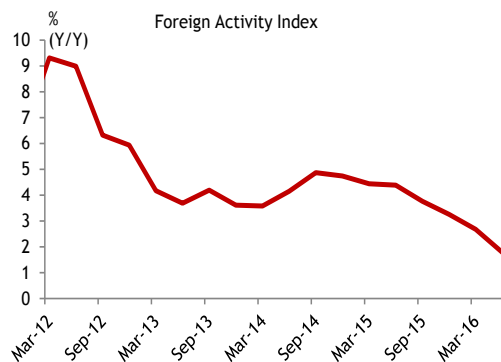
In fact, on both counts, dollar-sensitive industries underperformed non dollar-sensitive industries. This abnormal behavior suggests that despite a currency-induced relative improvement in labour costs, labour-intensive industries (of which, many are also C\$ sensitive) cannot be the chief catalyst of manufacturing growth in the near term. Capital-intensive industries must step up to the plate. That's not going to be easy given the high relative cost of capital equipment that trivializes any cost savings coming from lower energy prices.

## Manufacturing Exports—Not as Bad as Advertised

The Bank of Canada is waiting. We are waiting. But the big rotation from energy to non-energy activity is not here yet. Granted, there are many explanations for that disappointment. US demand for our products has been slowing (Chart 1). American consumers are buying more domestic services than the goods that we sell them and the manufacturing capacity lost during the dark days of parity is still compromising the ability of some industries to respond to what little demand there is out there.

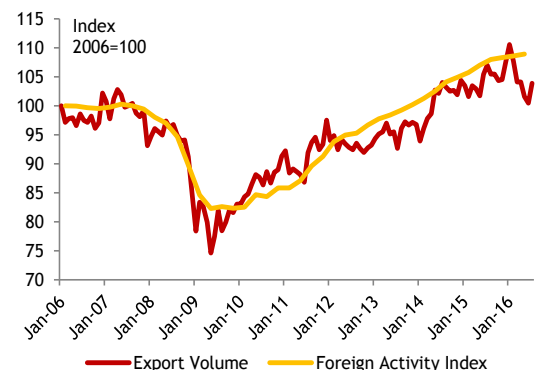
When you take all that into account and then glance at Chart 2, the performance of Canadian manufacturing exporters was actually not so bad given the cards they were dealt. The volume of manufacturing

Chart 1  
**Slowing Demand for Canadian Manufacturing Products**



Source: Bank of Canada, CIBC

Chart 2  
**Manufacturing Exports—Not so Terrible**



Source: Statistics Canada, Bank of Canada, CIBC

<https://economics.cibccm.com/economicsweb>

exports has risen by 12% since 2012 while demand as measured by the Bank of Canada’s foreign activity index has risen by 14%. Yes, the advance in manufacturing exports has been more of a step than a linear function—but the cumulative performance since 2012 is in fact better than advertised.

Now, we chose 2012 as a benchmark for a reason. That’s when the Canadian dollar started its descent. And as Chart 3 teaches us, industries that are more dollar-sensitive<sup>1</sup>, such as aircraft, plastic, pharmaceutical and medicinal products and communications, led the pack. Their export volumes are rising notably faster than industries that are less sensitive to fluctuations in the loonie.

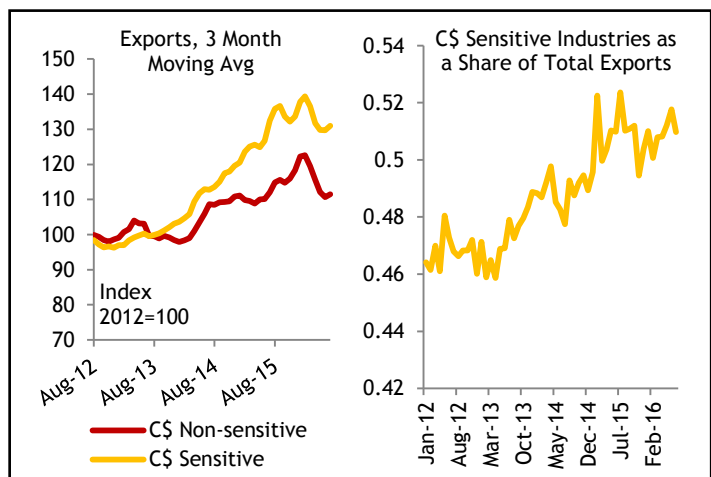
### No Positive Spinoffs

So the issue is not really export responsiveness to demand and currency movements but rather the spin-offs or the economic multiplier effect of that export performance. And a quick glance at Chart 4 tells us that those benefits are nowhere to be found. The industries that gained market share in exports underperformed when it came to employment gains. Ditto for GDP growth where dollar-sensitive manufacturing industries grossly underperformed less dollar-sensitive industries. This, by the way, is a new phenomenon. In past episodes of dollar depreciation, dollar-sensitive industries gained market share not only in exports but also in employment and production volume.

### Capital-Intensive Production—Lagging

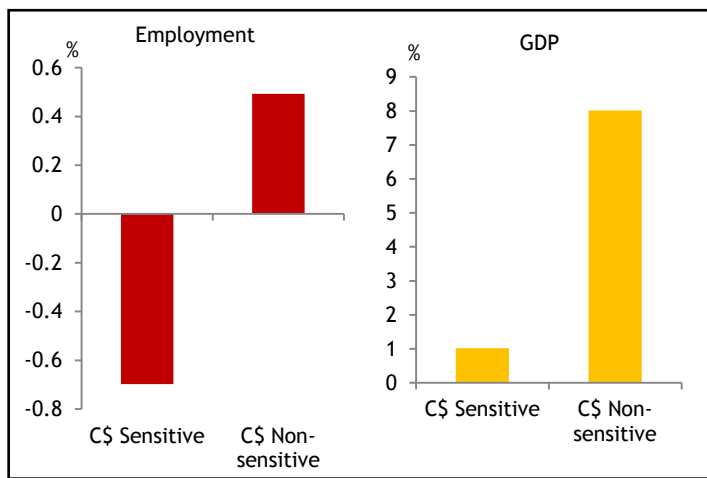
To get better insight into this curious trajectory, we should take a look at the nature of manufacturing activity over

Chart 3  
**No Surprise—C\$ Sensitive Industries Led the Export Recovery**



Source: Statistics Canada, CIBC

Chart 4  
**Surprise: C\$ Sensitive Industries Have Lagged in Employment and GDP Growth Since 2012**

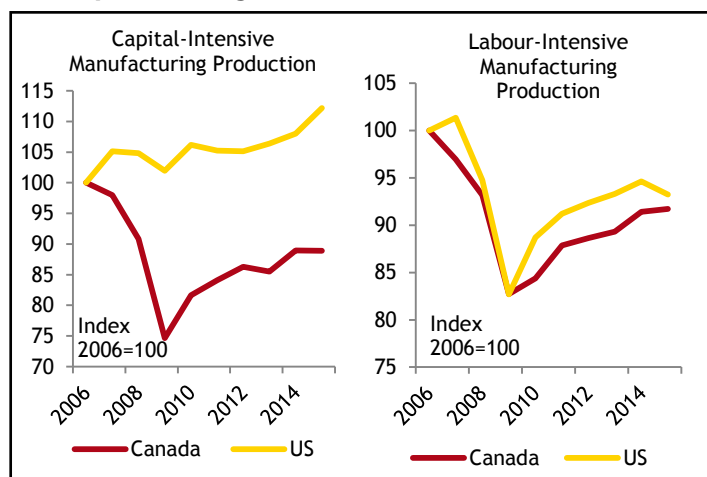


Source: Statistics Canada, CIBC

the past cycle (since 2006). Take a close look at Chart 5. While output for both labour and capital-intensive sectors in Canadian manufacturing fell dramatically during the recession, the damage to capital-intensive industries was notably larger. Those sectors recovered nicely since then, but production is still more than 10% below pre-recession levels, and it is still lagging the performance of labour-intensive sectors. But by far, the largest underperformance of capital-intensive Canadian manufacturers was relative to their US counterparts. For those capital-intensive American manufacturers, the mother of all recessions was nothing more than a blip. In fact, their production today is 12% above pre-recession levels.

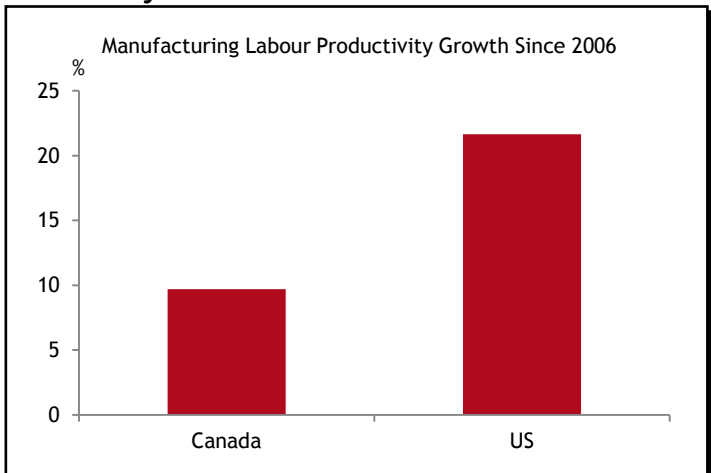
With capital-intensive manufacturing producers south of the border outperforming, and labour-intensive

Chart 5  
**Canadian Capital-Intensive Industries Underperforming**



Source: Statistics Canada, CIBC

**Chart 6**  
**Canadian Manufacturing Productivity Lagged During the Last Cycle**

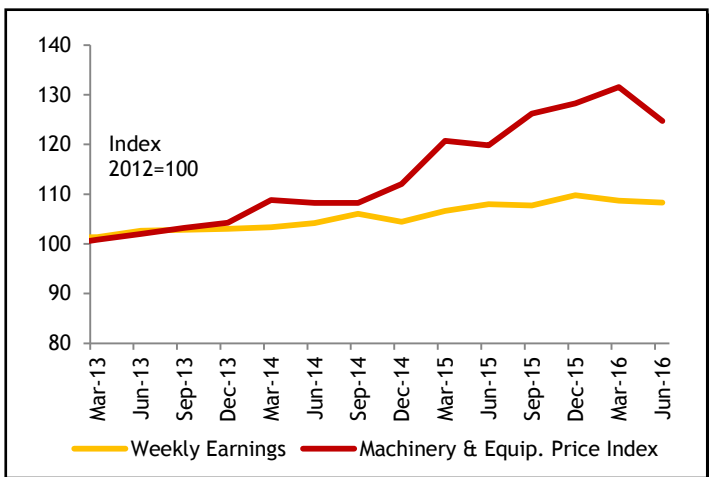


Source: Statistics Canada, CIBC

production roughly in line with what we have seen in Canada, US labour productivity has gained relative ground over the cycle (despite recent softening)—rising by an annual average of 2.6% since 2006—more than double the productivity gain seen in Canadian manufacturing (Chart 6). That productivity gap clearly worked to erode some of the benefits of a weaker dollar on relative Canadian unit labour costs.

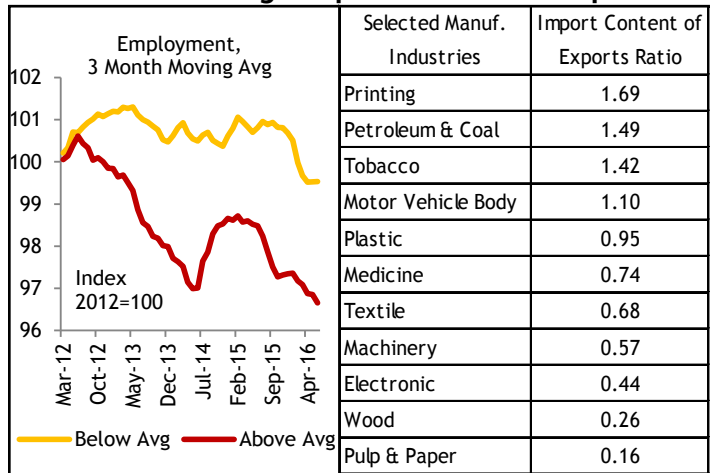
Now, the main benefit of a weaker dollar is to lower the relative cost of labour, in contrast to the skyrocketing cost of capital equipment (Chart 7). That trajectory suggests that the numerous companies that are both labour-intensive and C\$ sensitive should be substituting capital equipment for labour. But evidently, it's not happening. What's more, industries with a high import content of

**Chart 7**  
**Cost of Capital Equipment Rising Faster than Cost of Labour**



Source: Statistics Canada, CIBC

**Chart 8**  
**Faster Employment Deterioration for Industries with Above Average Import Content of Exports**



Source: Statistics Canada, CIBC

exports (where the impact of rising capital equipment cost is more evident) have seen their overall employment falling faster than sectors that have a relatively lower import content of exports (Chart 8)—reflecting squeezed margins and a slow rotation to more labour-intensive activity.

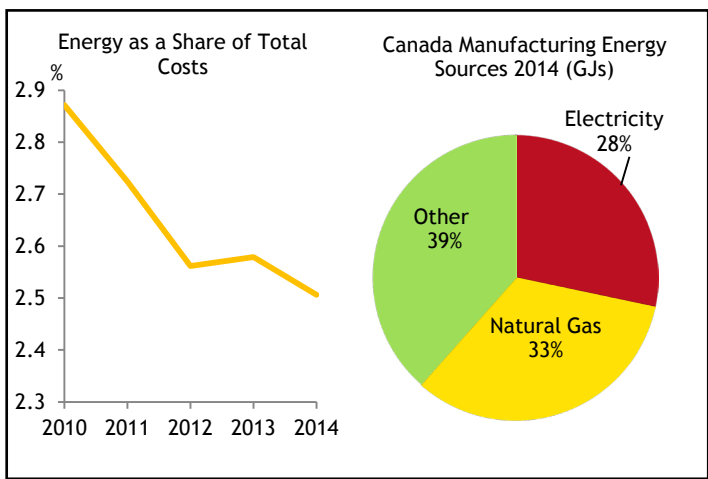
So the message is clear. If you don't hire more workers despite the fact that they are on sale, maybe you don't need more workers, or you can't find what you need. The different trajectories of labour and capital-intensive industries over the past cycle might suggest that we have reached a point in which the ability of labour-intensive industries to carry manufacturing is diminishing, and capital-intensive industries should step up to the plate. That's not an easy task given the rising cost of capital equipment.

**Energy Cost—Not a Macro Story**

While the cost of capital equipment has been rising, energy costs faced by Canadian manufacturers have been on the decline. At the margin that can help but those margins are very narrow. Energy accounts for a small 2.5% of total cost—down from 2.9% at the beginning of the decade (Chart 9).

Of course, you cannot discuss energy prices without mentioning electricity where prices have risen by a cumulative 33% since 2009 or 23% above inflation. In Ontario, electricity price inflation has been much more dramatic with prices rising 71% since 2009. While on average, electricity accounts for less than 30%

Chart 9  
Falling Energy Costs



Source: Statistics Canada, CIBC

of energy costs (and only 1% of total cost), for some electricity-intensive industries such as plastic products, electrical equipment, primary metals and transportation equipment, the cost of electricity can make a notable difference at the margin. But even here, in some cases the damage is mitigated by an ongoing substitution of electricity for natural gas (Chart 10)—which works to further reduce the overall sensitivity of Canadian manufacturing to swings in energy prices.

Footnote:

1. See "An Update—Canadian Non-Energy Exports: Past Performance and Future Prospects", *Bank of Canada Discussion Paper 2015-10*, for industry breakdown by dollar sensitivity.

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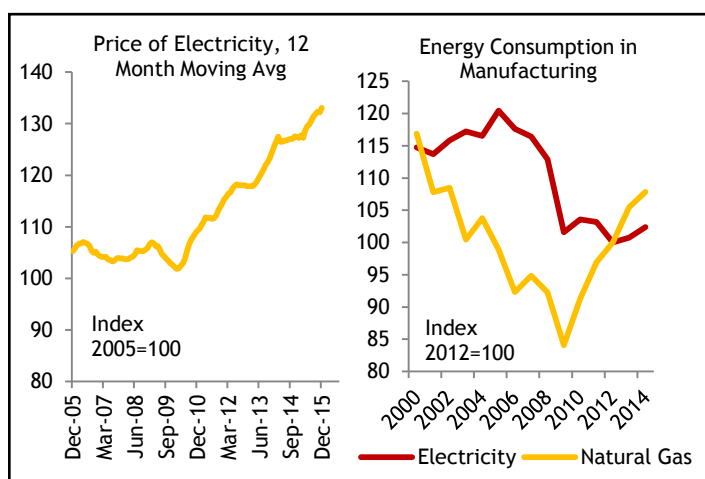
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Chart 10

Rising Electricity Prices... Triggering Substitution to Natural Gas



Source: Statistics Canada, CIBC

The disconnect between export performance and other real economic indicators in the Canadian manufacturing space might reflect the limited ability of labour-intensive industries to carry the torch. The shift to more capital-intensive activity will be constrained by the increased cost of capital equipment. The rotation is coming, but it might take even longer than currently expected.