Musing on investment trends in Canada and the US

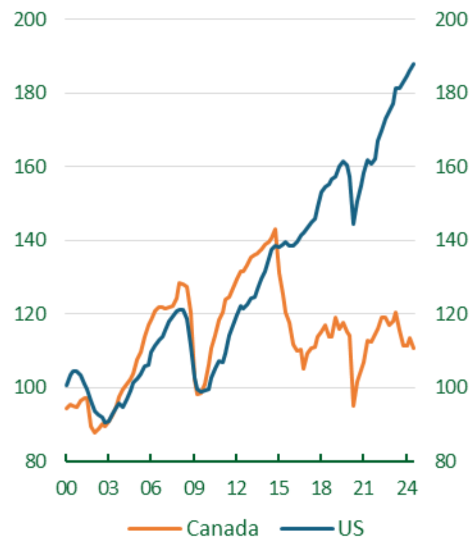
Resolve to no longer follow the "lesser path"

It's time to haul out some investment charts again and dig into the divergences between the trends in the US and Canada. Context is important regarding investment trends; what factors were key in driving those trends, and, more importantly, what factors played a lessor role. We then delve into some historical context.

Chart 1 shows a version of a chart that made the rounds last year. It shows real non-residential investment per capita in the US and Canada. Its companion chart 2 shows real non-residential investment to GDP ratios for the US and Canada. A version of this chart that has been circulating more recently.

1. Real non-residential business investment per capita

(2009 = 100)



Source: Macrobond, Statistics Canada, US BEA

The great divergence …

Both two charts tell essentially the same story:

Before 2015, the trends on both charts were very similar. Post-2015, they have diverged dramatically.

The natural question: What happened in 2015?

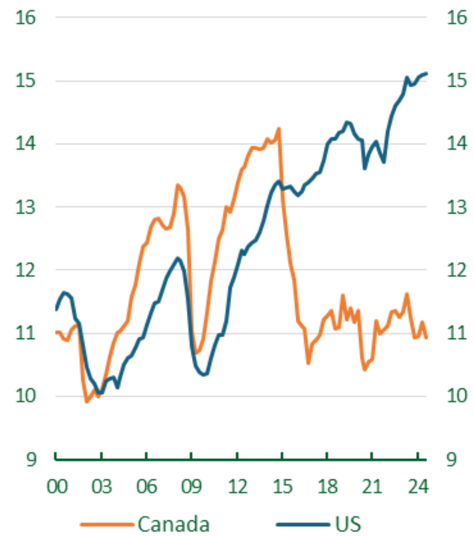
The easy — and lazy — answer is to note that Prime Minister Trudeau was elected in 2015, and that his government brought in an anti-business agenda that crushed investment in Canada. Unfortunately, this is little more than a gratuitous jab at the soon to be departed PM. If not fact-free, the assertion is at least fact-light.

There are two essential things to note:

First, the 2015 election was held in October, and the Liberal government was not sworn in until November. Hence, the plunge in real investment per capita and relative to GDP during 2015 can't be pinned on the Liberals. We can't even argue that the drop was in anticipation of the Liberals winning the election, since their victory was a surprise. During the gruelling 11-week campaign — as investment plunged — the fortunes of the contenders waxed and waned. At one point, the three leading parties were neck-and-neck, with the shift to the Liberals only gathering steam as election day approached.

2. Real non-residential business investment

(% GDP)



Source: Macrobond, Statistics Canada, US BEA

Second, let's look at charts 3 and 4. This gets us closer to the truth. The drop in real non-residential investment in 2015 came after oil prices plunged in 2014 (chart 3). This led to a sharp pullback in oil and gas (O&G) investment during 2015 (chart 4). Hence, rather than the result of the election of the Liberals, the sharp drop in investment in Canada is due to the substantial drag from collapsed oil prices.

… is the result of the collapse in oil prices in 2014 …

In fact, in October 2014 — a year before the federal election — the Bank of Canada noted that that lower global oil prices would reduce incomes and "*weigh on household and business spending*." The Bank also noted a downside risk to the inflation outlook from "*persistently lower-than-assumed oil prices*" that could "*have a material impact on investment and activity in the oil sector and the associated manufacturing supply chain*" (See, Monetary Policy Report, October 2014).

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From that point, oil prices continued to drop. As a result, the Bank noted opened its January 2015 Monetary Policy Report by stating — "*Oil prices have plummeted over the past six months*."

The Bank also said that the short-term risks to the economic outlook were skewed to the downside, and that "*the considerably lower profile for oil prices will be unambiguously negative for the Canadian economy in 2015 and subsequent years*." Business fixed investment was highlighted as key vulnerability, with a particular strain on junior and intermediate companies. The Bank projected that investment spending in the oil patch was expected to decline by 30% during 2015. As a result of the implications of the sharp decline in oil prices on the economic outlook, the Bank of Canada reduced its policy rate in January 2015.

As it happened, the pull-back in non-residential investment was severe enough that it resulted in two quarters of negative GDP growth — a so called "technical recession." The episode is not classified as a recession as the economic impacts were most pronounced in Alberta, rather than reflecting widespread economic weakness. A profound shock to the economy, nonetheless.

These developments were long before the 2015 federal election.

… it was not related to the October 2015 federal election

The Liberals were not responsible for the decline in oil prices or for the severe drag on investment during 2015 or the weak investment performance through 2017, in large part because oil prices remained very low throughout this period.

That said, I think that the Liberals do bear some of the responsibility for the lacklustre post-pandemic rebound in investment. There did no seem to be a sufficiently intense focus on making Canada a more attractive investment destination thus contributing to Canada's lagging productivity performance. (***Aside and foreshadowing***: *Competitiveness and productivity challenges long pre-dated the current Liberal government*.)

Charts 5 and 6 highlight a development that deserved serious attention. Chart 5 shows the trends in per capita investment for total real business investment and its oil and gas (O&G) and non-O&G components. Note the collapse in O&G investment between 2015 and 2017.

Non-O&G investment suffered some modest spillover effects from the drop in oil prices but was largely stable in per capita terms. What draws my attention, however, is the mediocre trend in real per capita non-O&G investment post pandemic. While one can say that this was merely the effects of the surge in population, there are fundamental questions about the poor performance.

Chart 6 reinforces these observations showing a breakdown of the real non-residential investment to GDP ratio into O&G and non-O&G components. Before the collapse in oil prices, O&G investment contributed an average of 4.0 percentage points to the real non-residential investment to GDP ratio. Since 2016, the contribution from O&G investment has declined by over 50% to an average of 1.5 percentage points. In fact, the average contribution between 2016 and 2019 was 1.7ppt, while the contribution during the post-pandemic period has been 1.3 ppt. This lacklustre trend might have been more sensitive to the political situation in Canada.

To be fair, as oil prices increased since 2000, there has been an upswing in O&G capital expenditures, projected to have been CAD44bn in 2024, and to be close to CAD50bn in 2025, according to Statistics Canada's recently released Non-residential

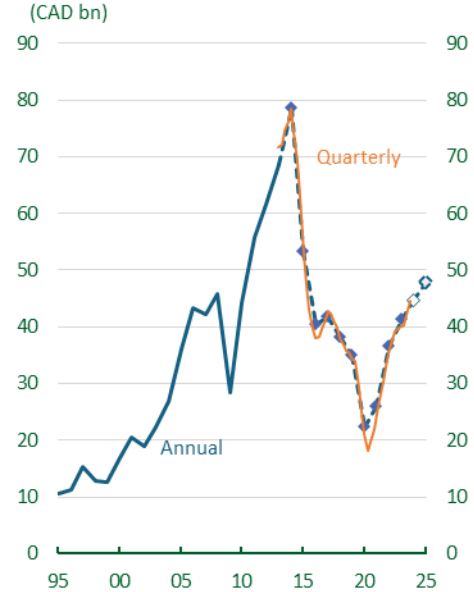
3. WTI oil price

(USD/bbl)

Source: Macrobond, US EIA

4. Oil and gas investment

(CAD bn)



Source: Macrobond, Statistics Canada

capital and repair expenditures survey. These observations are highlighted by the hollow diamonds in chart 4. However, these capital expenditures are in current or nominal dollars and won't necessarily do much to improve the trend in the real O&G investment to GDP ratio.

Turning our attention to non-O&G investment, we see that this component has consistently contributed between 9 and 10 percentage points to the real non-residential investment to GDP ratio since 2013. Something that stands out here is the most recent trend in the non-O&G investment to GDP ratio. Since mid-2023, this ratio has been trending downward, and it is back near levels observed in late 2016 and early 2017.

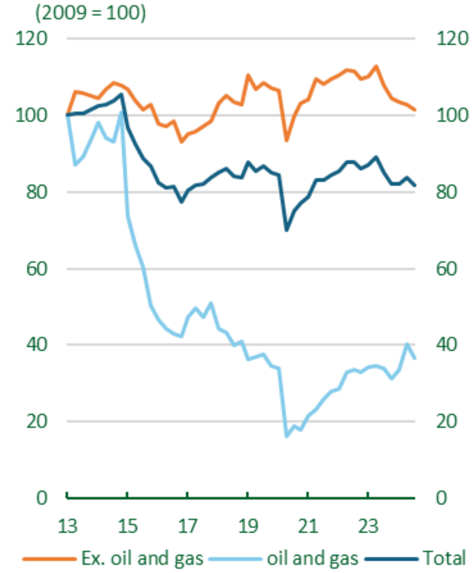
The Liberal Party might not have been able to do much about the O&G investment ratio, but they should have more ambitious regarding the non-O&G investment ratio to help offset that investment in the oil sector had remained far below previous levels.

However, there is quite a bit of blame to spread around. As shown in Chart 7, the real non-O&G investment to GDP ratio has remained between 9% and 10% since 2005. We can, and should, question the current Liberal government about the lack of concrete action to boost non-O&G investment during their tenure, their performance on this metric is on par with earlier governments. What differs is that the Liberals did not have strong O&G investment in their back pocket to lift overall investment ratios to healthy levels.

The dreary news in chart 7 also highlights that the productivity challenges facing Canada at the present time, have been developing for years and years.

5. Real business non-residential investment per capita

(2009 = 100)



Source: Macrobond, Statistics Canada

This time really is different

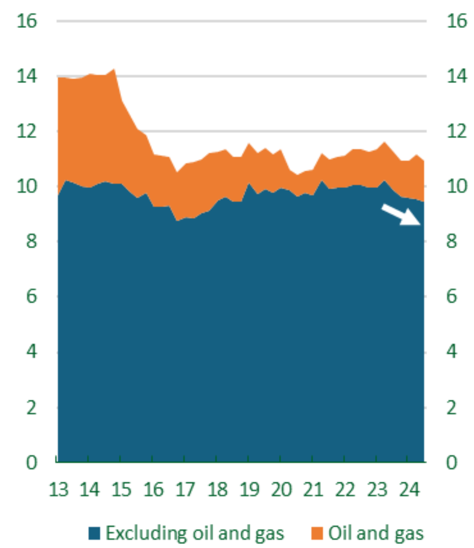
The weak investment/low productivity problems long pre-dated the current government. It has been a bipartisan effort. However, under threat from an aggressive US administration that is undermining key economic linkages, the problems can no longer be swept under the rug.

It is unlikely that we can reverse these trends overnight. However, that does not take away from the urgency of having to change things around. Unfortunately, every Canadian economist has a stack of policy position papers, research reports, and academic studies describing Canada's productivity/competitiveness challenges with proposals for how to turn things around. Yet, here we are.

Below I reproduce a key graphic from the Liberal Government's 2018 Economic Strategy Tables. Many of the Key Performance Indicators make absolute sense. I fear that if we were to show current readings on those key indicators, Canada's ranking would be little changed. While the pandemic was a disruption that likely limited gains in some ways, it is weak to lean too heavily on that argument. We need to reinvigorate a focus on improvements along these metrics and establish credible targets to hit.

6. Real non-residential business investment

(% GDP)



Source: Macrobond, Statistics Canada

That said, the issues highlighted here have long, long been under examination. For example, in 1991, Michael Porter and John Armstrong (representing the Monitor Company) published **Canada at the Crossroads: The reality of a new competitive environment**. In crucial ways that report is as relevant today as it was then.

Rather than focus on that report, I want to look at a 2001 report by Roger Martin and Michael Porter called Canadian competitiveness: A decade after the Crossroads. In this report, the authors (including the primary author of the original piece) examine how things unfolded since the 1991 report.

To start, here is a passage on the key recommendations from the 1991 report:

"*We found Canada to be at a critical crossroads as of 1991. Due to Canada's impressive endowment of natural resources, its well-educated population, and its proximity to the US, the nation had enjoyed economic prosperity and a high standard of living. However, we concluded that this favorable situation was likely to erode and produce a decline in standard of living unless Canada and its firms chose a distinctly different path.*

We outlined an alternative path that could retain and enhance the nation's competitiveness. We recommended that governments move aggressively to restore a favorable macroeconomic context for Canadian business by tackling the budget deficit and reducing personal and corporate tax rates. We also recommended that governments eliminate the barriers to inter-provincial trade and investment that relaxed competitive pressures and fractured an already small economy.

With respect to the microeconomic business environment, we offered recommendations in each of the four areas. With respect to Context for Firm Strategy and Rivalry, we recommended that governments pursue policies to enhance the intensity of domestic competition rather than try to produce national champions shielded from competition in the home market. In Demand Conditions, we recommended that governments adopt more stringent and forward-looking regulatory standards and restructure government procurement to make the government a more sophisticated and demanding customer. With respect to Factor Conditions, we encouraged governments to invest more heavily in education and specialized skills development and to step up the pace of deregulation in infrastructure sectors. In addition, we encouraged technology development policies more connected to industry clusters and mechanisms for faster adoption of new technology."

7. Real non-O&G investment

(% GDP)

Source: Macrobond, Statistics Canada

Catching my attention was the discussion of competition. It is still very relevant as Canada continues to struggle with the "intensity of domestic competition." In fact, domestic competition might be even worse now as discussed by Denise Hearn and Vass Bednar in The Big Fix.

Also, with a focus at firm level issues they said:

"*We also outlined a new trajectory for Canadian firms. The central challenge was to move to innovation-driven modes of competing –i.e. sophisticated processes and products- rather than competing on raw materials or labour cost advantages. To do so, it would be necessary to rationalize product lines, reduce levels of diversification and dedicate more attention and resources on upgrading the Canadian home diamond. Firms needed to develop the capacity to sell in important markets globally and tap into leading-edge research excellence in specialized technologies*."

The passages above would fit almost perfectly in any contemporary report on Canada's competitive/productivity challenges.

It is also disheartening to read their observations on how things unfolded between 1991 and 2001. Here two key takeaways:

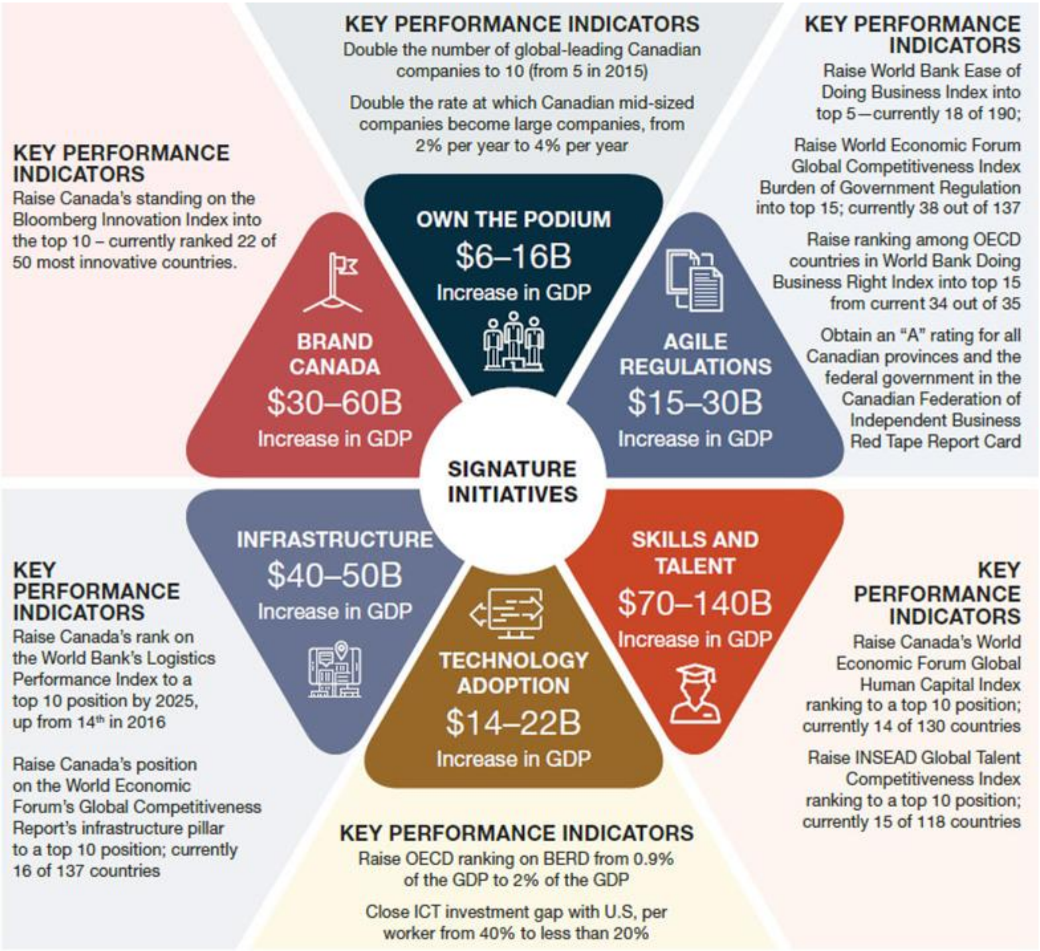
"*Consistent with its performance on standard of living, Canada registered strikingly poor performance in productivity growth*."

"*Canada took the lesser path from the crossroads in 1991. There has not been a clear and relentless focus on upgrading productivity and pursuing global competitiveness*."

Little it seems has changed.

Resolve to no longer take the lesser path

While Canada's investment trends have diverged dramatically from US trends in the past decade — weighing heavily on productivity growth and competitiveness — let's also acknowledge that Canada has been coasting for over 30 years. The challenges have long been identified, solutions have been suggested, but when given the choice "*Canada took the lesser path*." We can't continue past behaviour. The challenge presented by Trump47 means this time really is different, so Canada needs to take another path.



Source: Report from Canada's Economic Strategy Tables: The Innovation and Competitiveness Imperative, 2018