PALOS

Palos Weekly Commentary

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Macro View

By Hubert Marleau

The Canadian Dollar as of May 16, 2019

A few weeks ago, the Palos Monetary Policy Index for Canada stood poorly at 36 and the inflationary content of the misery index was low at 20%. Canada's economy was experiencing a significant slowdown--so pronounced that many believed that a recession was barely avoidable. Perception was bad enough to drive the exchange value of the Canadian dollar to 73.25 US cents, far below its PPPR of 77.25 US cents and the Neutral Rate 0.25% beneath the Policy Rate of 1.75%. The Canadian bond market was pricing a 70% probability of a Bank of Canada benchmark rate cut within three months. In effective terms, the Loonie was trading way below its 10-year average, suggesting that an awful lot of bad news was priced in. Then suddenly out of nowhere, a series of unexpected bullish economic prints became evident--higher housing starts, lower unemployment, higher energy prices and more optimistic purchasing managers. The new data surprised the financial markets, killing the belief that the Bank of Canada imminently was about to cut its target rate, giving credence to the "Poloz belief" that growth will soon pick-up. In this respect, interest rate differentials between Canada and the U.S. widened in our favour and the CDN dollar shot up.

I argued in previous commentaries that the exchange value of the Canadian dollar is dependent on three factors. Terms of trade which are basically a function of oil prices, the perspective difference between Canadian and American monetary stances and the attraction of Canada as an investment destination for foreigners. At the time of this writing, the price of oil is up 35% year to date and continues to hover above its marginal cost of production, record amounts of foreign capital are pouring in the financial markets and the implied chance of a rate cut is now only 30%. On the surface, the outlook for the Loonie looks good; but sustainability will depend on how well the Canadian economy can hold-up. It's not easy to read the prospects for the economy when conflicting signals in the labour market are confusing forecasters. The foundation of any economy is based on the labour market as it pertains to its speed of growth and its level of productivity. There seems to be a marked difference between the booming labour market and slow-moving productivity.

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On the one hand, statistics on employment growth are excellent. For example, in Q1 employment rose at the annual rate of 2.8% for a yearly increase of 1.8%. The labour market silenced the doubters in April, delivering a huge employment gain of 108.1K and generating a year-over-year increase of 2.1%. There appears to be more room to run and more slack to drain---wage growth is low, young people are entering the labour force en masse, the tide of job openings is rising, and immigration is feeding the labour force.

On the other hand, gains in labour productivity are uninspiring and chronic with no net change since 2014. The stall in productivity is symptomatic of the decline in competitiveness that many corporate executives cite regularly in business papers. We already know from the Bank of Canada and private forecasters that the underlying growth for Q1 is south of 1.0% and that real output for Q/2 is not going to be any better than 1.5%.

Businesses are not applying enough capital for labour to raised productivity. They are not reducing the number of workers required to produce a unit of GDP-Output. They are using cheap and flexible labour rather than implementing costly productivity enhancement investments. Business investment remains about 10% below its 2014 peak. Impeded by too much taxation and regulation, many businesses are not willing to commit capital that would force them to stay in Canada for the long term. Instead, they prefer to hire people, effectively substituting labour for fixed capital formation to meet the spending demand of a fast-growing population. This kind of operation keeps them flexible. A situation that may last for a while longer until the air clears up. Interestingly, more and more part-time workers are turning into full-time employees, supporting the above observation. In April,19% of total employment were part-time workers—-3.6 million —-and 5.8% of the labour force were unemployed—1.2 million people were actively seeking a job. That's a total of 4.8 million people on which businesses can depend to raise production without flushing capital down the tube. Moreover, the labour participation rate is historically low, many points below where it was before the financial crisis, suggesting that there are still a lot of unregistered workers that could potentially look for work.

Two More Asides on Productivity:

Jeffrey Simpson, a senior fellow at the Graduate School of Policy and International Affairs at the University of Ottawa, wrote a commentary for the MLI titled "Uncertainty and Confusion in Canada's Natural Resource Development" which partially explains why no one wants to invest in Canada's resources. The point is that while the modern Canadian economy is largely diversified, natural resources plays an incredibly important role when it comes to creating economic opportunity and prosperity. Yet, Canada's struggle to get pipelines built and LNG projects off the ground is bad news for productivity. Simpson makes the case that the review process for projects too often becomes bogged down. First Nations with legitimate impact claims are often not clearly understood by all parties; the representatives for First Nations communities are often unclear; Canada's courts seem to muddy the waters even more, unable to provide consistent answers regarding precedent in these cases; government often adds hoops to jump through or new layers of review for projects. He said: "What is unusual and hurtful is the degree to which Canadians on properly conceived projects have added to necessary conditions--land use, environmental protection, impact on nearby communities--excessive litigiousness, indigenous legal claims, widespread definitional confusions, regulatory uncertainty and political

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controversy.” Until this debate is resolved-- if it can be resolved--any company thinking of investing must tread very warily. The bottom line is “Time is money, and the more time that is spent consulting and negotiating, the greater the chance that a company will walk away or, looking at precedents, decide not to invest.”

Sean Speer, a Conservative and Richard Asselin, a Liberal, in a report for the Public Policy Forum, raised red flags about the loss of intellectual property to foreign players and outlined the hit to Canada’s competitiveness in a world increasingly driven by big data and other types of intangible assets. It does not take much imagination to figure that the economics of knowledge-based growth which is premised on the idea of generating economic rent from intangible assets can bring enormous productivity. Suffice it to say that Canada’s spending on IP as a share of the economy is trending downward and so has the number of Canadian patents over the past decade--Statistic Canada. Data compiled by Bloomberg show there are no Canadian firms among the world’s 200 spenders on R&D. For as long as we prefer to be a tenant nation of the new intangible economy rather than a landlord nation, collecting rent, productivity gains in this sector will be a challenge.

As a final note, it will be a tough slog to get the Canadian dollar back to its PPPR without better immigration policies, without better policies for the development of natural resources and better promotional policies to increase and keep IP. I admit that the political will to make policy changes is emerging. The general population is taking notice as people are politically bitching nor enough is being done to remedy the situation.

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