Economics

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Parsing Canada's productivity gap

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Higher productivity is a straightforward way to limit inflationary pressures, and it doesn't come along with the negative ramifications of higher interest rates, which are currently heading to levels that will stall growth on both sides of the border over the remainder of the year. Canada's underperformance in productivity has worsened since the onset of the pandemic, with the impressive pace of employment growth not having been matched by gains in GDP, which is working to amplify inflationary pressures through higher unit labour costs.

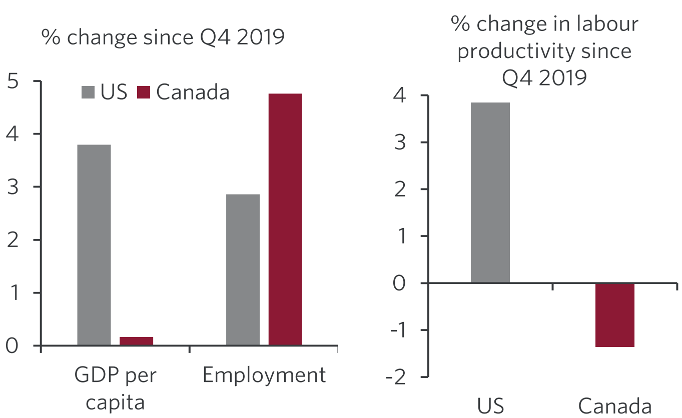
It's no secret that Canada has a longstanding labour productivity issue, having lagged the US for decades. Canadian companies are generally less capital intensive and don't reap the benefits of returns to scale that their larger American counterparts do. And the productivity gap between the countries widened during the pandemic (Chart 1). But when looking into the industry level data, we see reason to expect a rebound in productivity in some sectors, which will work to aid the Bank of Canada's efforts to get inflation back to target.

The good, the bad and the services

Looking at the period since Covid started to fade away, labour productivity has been receding on both sides of the border, which is a direct result of the removal of public health restrictions that mainly targeted lower-value added services that are now rebounding. That normalization in activity is also occurring against the backdrop of a deterioration in higher value-added service sectors that were booming during the height of the pandemic, particularly the tech sector.

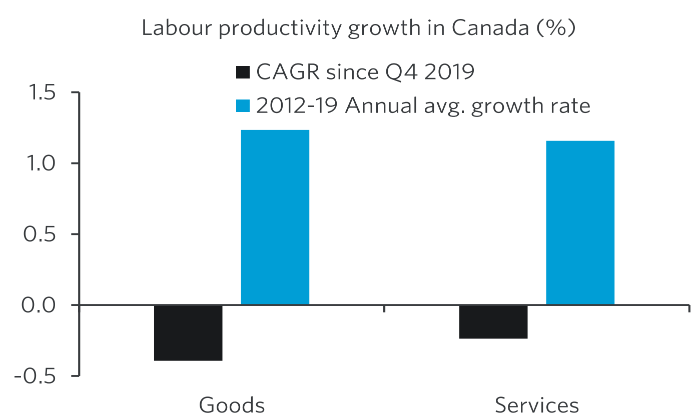
We focus on industry-level data to gain insight into Canada's productivity underperformance. Surprisingly, we find that Canada's recent underperformance is not entirely concentrated in goods sectors, where capital expenditures have been sluggish, but it's also widespread across service sub-sectors since the onset of the pandemic (Chart 2).

Chart 1: Labour productivity has stagnated in Canada relative to the US since 2019



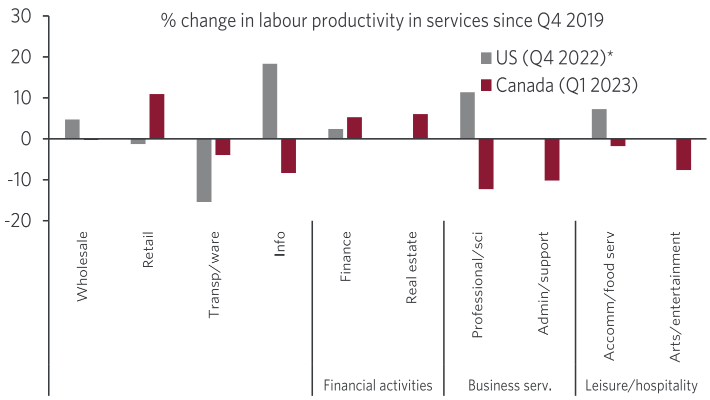
Source: Statistics Canada, BEA, BLS, Census Bureau, CIBC

Chart 2: Weak productivity in Canada not just a goods sector story



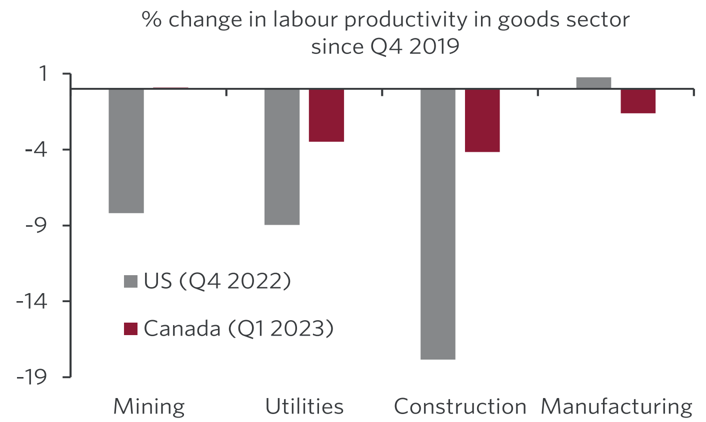
Source: Statistics Canada, CIBC

Chart 3: Productivity by services sub-sector



Source: Statistics Canada, BEA, BLS, CIBC. *US data not disaggregated into sub-categories for financial activities, business services, and leisure & hospitality.

Chart 5: Productivity by goods sub-sector



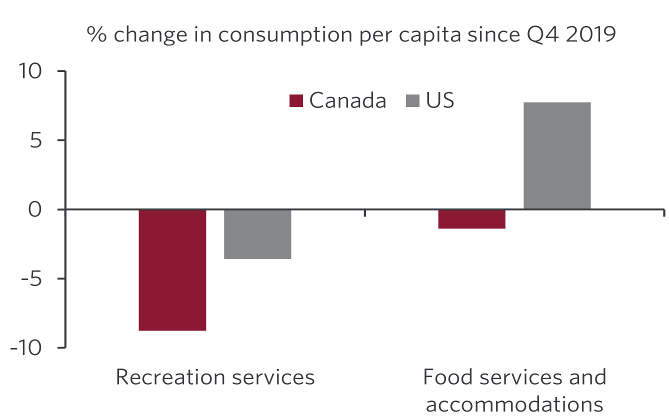
Source: Statistics Canada, BEA, BLS, CIBC

Admittedly, real output and productivity can be difficult to assess in services due to output being intangible in some cases, particularly in information and business services, which are two areas that Canada has underperformed in (Chart 3). But some of the weakness in other service sub-sectors is concentrated in areas that were directly impacted by the pandemic, namely leisure and hospitality, and could be poised for a rebound in productivity ahead.

Recreation and food and accommodation services are operating at lower capacity relative to pre-pandemic levels in Canada versus the US, with consumption per capita lagging what's been seen stateside (Chart 4). That gap could narrow as Canadians increasingly return to these high-touch services as Covid fears continue to fade, which would help to contain unit labour costs in these industries that are currently almost 30% above their pre-pandemic trend level in arts and entertainment, and 4% above in accommodation and food services.

The aggregate figures also mask some areas of strength in Canada, namely retail trade and financial activities.

Chart 4: Room for a rebound in Covid-impacted services



Source: Statistics Canada, BEA, BLS, CIBC

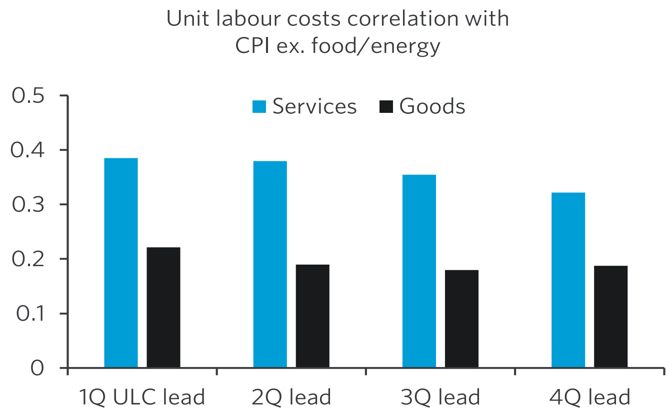
Interestingly, in the former industry, Canada maintains a lower share of online sales within total retail sales, and the US has magnified its reliance on online retailing more than Canada during the pandemic, but Canada has seen a faster recovery in retail trade output.

Weak productivity growth in Canada is typically viewed through the lens of goods sectors that were plagued by supply chain issues during the pandemic, and where capital spending has lagged historically. However, Canada generally hasn't done as poorly as the US in these sub-sectors in terms of productivity since the pandemic began (Chart 5).

Although we expect business investment to slow along with higher interest rates, there are some reasons for optimism when interest rates start coming down. Nominal capital spending intentions in manufacturing were at the highest level in over a decade in the survey period that ended in January 2023, although some of that could reflect higher prices for capital equipment and industrial construction, rather than higher volumes. And capital spending intentions in the mining industry were reported to be 14% higher in 2023 in the same survey, although that will still leave nominal spending below the peak levels reached in 2014.

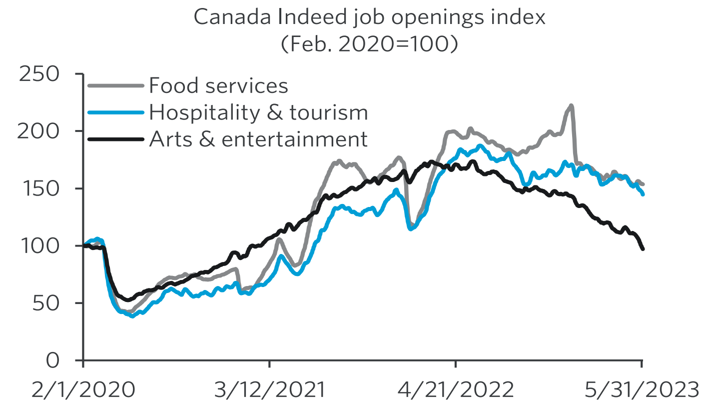
With cyclical goods sectors poised to slow with higher interest rates, a rebound in services productivity could aid the Bank of Canada in cooling inflation. Correlations show the strongest link between unit labour cost decelerations and lower inflation in the subsequent quarter (in y/y growth terms) following a unit

Chart 6: Strong correlation between services unit labour costs and core CPI



Source: Statistics Canada, CIBC

Chart 7: Job openings in discretionary services trending lower through Q2



Source: Indeed, CIBC

labour cost easing, particularly in service sectors (Chart 6). And there are still substantial impacts in the two quarters after that, suggesting that any improvement in services productivity could be a relatively swift way to help limit inflation. In contrast to services, core inflation tends to lead changes in unit labour costs in goods sectors.

Summing it up

The other side of lowering unit labour costs will come from slower wage growth, which seems to be in evidence this year already in the US. Canada, in contrast, has made more progress in lowering job vacancies per unemployed person, which should put downwards pressure on wage growth ahead. Indeed, industry data shows that Canada is continuing to see a downward trajectory in job openings in discretionary services in Q2 (Chart 7).

The Bank of Canada could use some help from a productivity boost to get inflation under control, and the data seems to suggest that there could be a rebound in key service areas, where unit labour costs are a better indicator of future core inflation. If that's the case, then the Bank of Canada should be able to stop hiking after a final 25bp hike, and contained unit labour costs will also allow for a trimming of interest rates starting in Q2 2024. Further out, there seemed to be more appetite for capex by goods sector businesses surveyed early this year, and that could work to improve productivity in the medium term if executed once interest rates fall.

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