

Economics

IN FOCUS

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Canadian GDP: Still some low-hanging fruit to pick

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Facts can change, particularly when they rely on volatile economic data. At the moment, though, GDP growth appears to be running stronger than the Bank of Canada had assumed a month ago, creating a slight headache for policymakers.

In this case, however, stronger than expected growth does not appear to be an inflation threat, and should therefore not prove an additional barrier to cutting interest rates ahead. Much of the improvement stems from an easing of previous supply disruptions that impacted manufacturing, auto sales and other sectors.

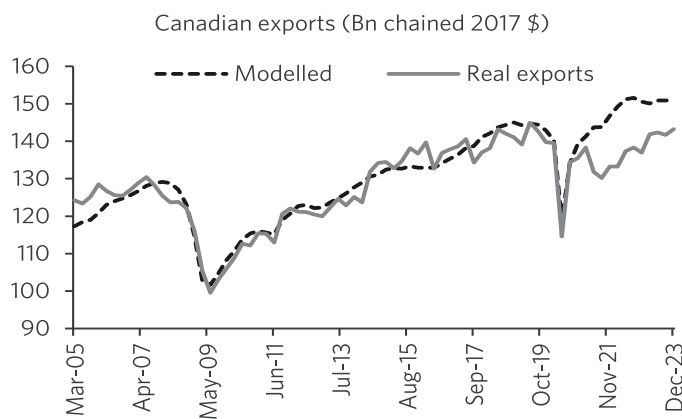
A supply-induced lift to output could show up in a long-overdue rebound in productivity, and wouldn't be a sign of strengthening domestic demand. And even after the potential Q4 rebound, there appears to be more of this low hanging fruit ready to be picked if supply disruptions continue to ease, helping the economy avoid the recession many have long been forecasting.

A little help...not just from our friends

Throughout last year, net trade was an important source of growth for the Canadian economy. As of Q4, goods exports were nearly 5% higher year-over-year in volume terms, while imports were largely unchanged. While a surprisingly strong US economy partly explains that performance, an easing of earlier supply disruptions also played an important part.

Through a combination of semi-conductor shortages initially, then port strikes, wildfires and other disruptions, exports have trailed their previous relationship with the Bank of Canada's foreign activity index since mid-2021 (Chart 1). Although recent export performance has narrowed that gap somewhat, there appears to be scope still for further growth as bottlenecks ease. Indeed, if this gap were to completely close, the boost to Canadian GDP would be around 1%, even after accounting for the import content of Canadian trade.

Chart 1: Exports playing catch up with global demand

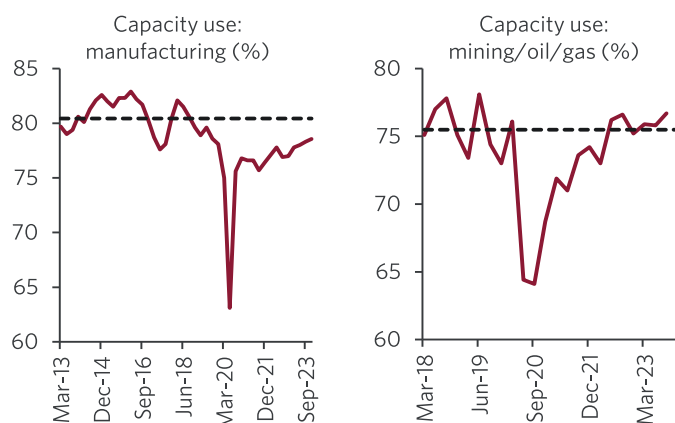


Source: Statistics Canada, BoC, CIBC

*Modelled using the Bank of Canada's Global real activity for Canadian exports index

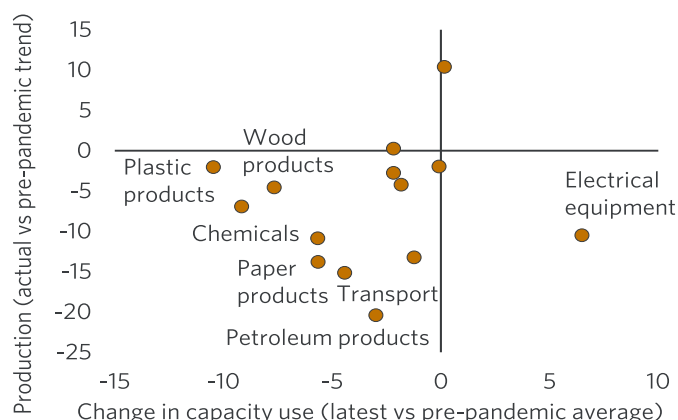
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Chart 2: Manufacturing capacity use still recovering (L), but mining, oil & gas back to pre-pandemic level (R)



Source: Statistics Canada, CIBC

Chart 3: Some areas of manufacturing have seen production hampered by low capacity use



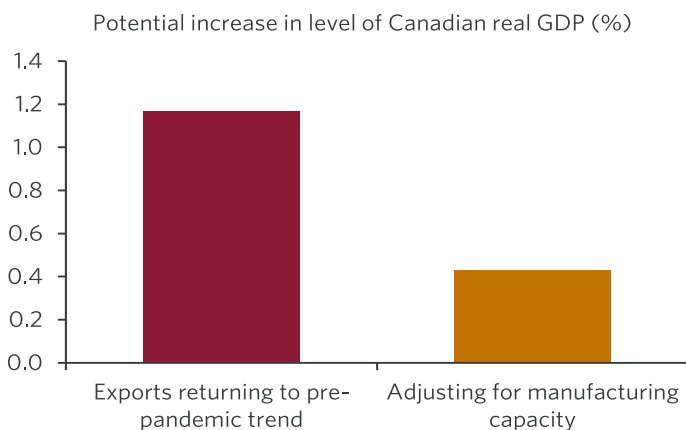
Source: Statistics Canada, CIBC

Whether we can get that full boost doesn't just rely on an easing of earlier supply issues, however. It also relies on the Canadian economy still having the capacity to produce what buyers are demanding. Here the results aren't quite as positive, with mining, oil & gas capacity use having already recovered close to its pre-pandemic average, and the manufacturing sector edging closer to that average (Chart 2). While the opening of a major pipeline in Canada should help the spread between domestic and global prices, there may not be much scope in the near-term for further increases in production.

For the manufacturing sector, even though production levels in such industries as transportation and petroleum products are below their pre-pandemic trend, utilization rates suggest that this is at least partly due to a loss of capacity. However, there does appear to be scope for production increases in areas such as plastic products and chemicals, if global demand holds up (Chart 3).

So, after adjusting for capacity utilization rates, there still appears to be scope for production and export growth as supply

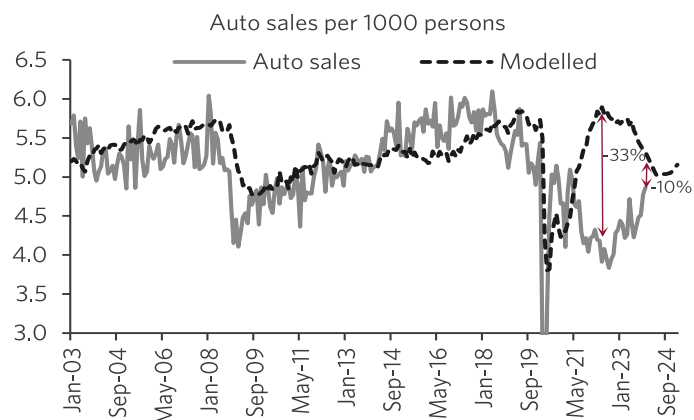
Chart 4: Still scope for export boost to GDP even after accounting for manufacturing capacity



Source: Statistics Canada, CIBC

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Chart 5: Even after recent improvement, auto sales still slightly weaker than expected



Source: Statistics Canada, CIBC

issues fade. That room to run isn't quite as wide as implied by the gap between export volumes but it may be enough for GDP to be 0.5% higher without adding much to domestic inflationary pressures because it will be driven by an increase in the productivity of capital (Chart 4).

Restocked car lots

An easing of past supply issues in the manufacturing sector isn't the only low hanging fruit ready to be plucked by the Canadian economy this year. Strike action in Quebec towards the end of last year impacted GDP in some sectors which will see a rebound in early 2024, again creating more output without additional hiring. There also appears to still be scope for auto sales to rise, even in today's higher interest rate environment, as previously ordered vehicles are finally delivered.

Using interest rates and the unemployment rate to create a simple model of per capita auto sales, sales were more than 30% below their modelled level during the worst of the supply disruptions in 2021/22 (Chart 5). While interest rate hikes and a rise in the unemployment rate suggest sales should have fallen by around 10-15%, we were recovering from a level much lower than that. Indeed, even with an improvement in 2023, there may be scope for a further 5-10% increase in auto sales if supply chains fully ease and the economy doesn't weaken any more than our current expectation. Industry data for January already points to a further improvement to start 2024.

Admittedly, the high import content in the auto industry means that any further pick-up in car sales won't have a big impact on aggregate GDP. However, it could result in consumer spending looking stronger than many, including the Bank of Canada, currently expect.

Picking the low hanging fruit

If supply chain issues were fully resolved and all of the remaining low hanging fruit were to be picked, we estimate that

the level of Canadian GDP could be around 0.5-1.0% higher without materially adding to current inflationary pressures. That's because this growth would represent a more productive use of current capital in the manufacturing sector, or car salespeople finally being able to fill orders that had already been placed. Obviously, this may not happen all at once, or at all given the continued threat of new strike activity and supply disruptions as other collective bargaining negotiations continue.

Fine tuning near-term GDP forecasts is not the main point of this analysis, however. Rather, we are trying to understand how much potential there is for supply-driven growth that could increase output without creating additional inflationary pressures. That appears to have been an important part of the story for the final quarter of 2023, and potentially the first quarter of 2024 as well. Because of that, our slightly higher near-term profile for Canadian GDP has not impacted our forecast for a first interest rate cut in June.

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