Economics

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January 29, 2026

Closing Canada's manufacturing gap: A capital idea

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US manufacturing GDP is almost 10% above its pre-Covid level. Canadian manufacturing GDP has yet to reach 2019 levels. The US performance is not only stronger but it's also much more capital intensive. This has major implications not only for productivity and profitability (capital-intensive manufacturing firms are more profitable), but also for the extent to which policy makers should focus on job growth as an indicator of economic health in the sector. And this is just the beginning. The rapid pace of AI technology adoption means that capital intensity in US manufacturing will rise even faster in the coming years. Can Canada keep up?

Manufacturing underperformance

The underperformance of the manufacturing sector in Canada vs. the US is not new. Over the past two decades, Canadian manufacturing GDP has decreased by an annual average pace of 0.6%, relative to an average increase of 1.3% in the US. The pandemic did not change that trajectory. In fact, annual Canadian manufacturing GDP has lagged the US by 2%-pts. on average since 2019 (Chart 1).

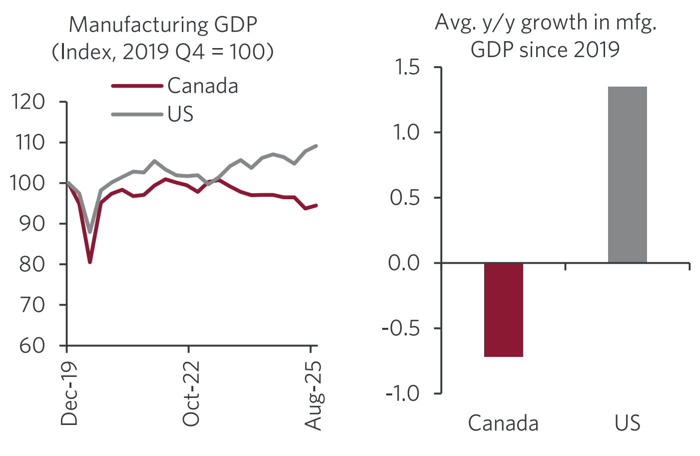
Capital intensity

The ability of the US to generate more output is a reflection of the fact that the US manufacturing sector is highly capital intensive. Capital intensity, defined as the ratio of capital services to hours worked in the production process, has risen by an annual average of 3% since the late 1980s. Granted, the shift from labour-intensive to capital-intensive production is not new, but it appears that the process is accelerating. From 2019 to 2024, the US capital-intensity index rose by more than 10%, compared to just under 8% in the previous five-year period.

And this is just the beginning. Note the rapid acceleration in capital intensity during the dot com revolution (Chart 2) and you get a preview of what's coming in the AI era. In fact, with the adoption pace of AI technology projected to be much faster than what we saw in the 1990s, that trajectory might be much faster (Chart 3).

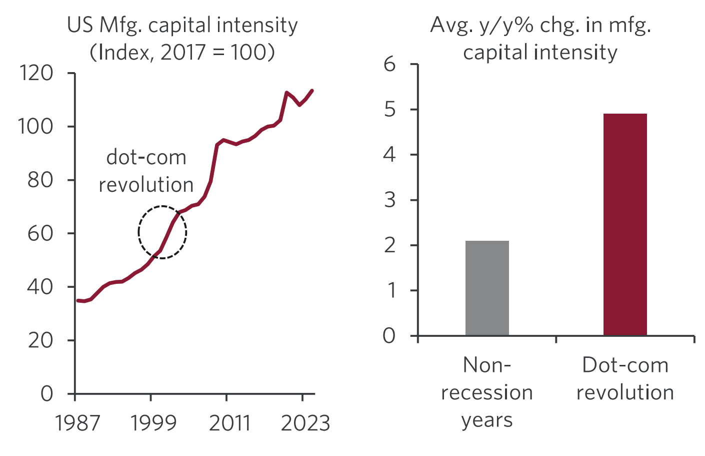
In Canada, the situation has been completely different. The more muted manufacturing recovery was also less capital-intensive, with the ratio of production in capital-intensive

Chart 1: Manufacturing performance gap has widened in favour of the US



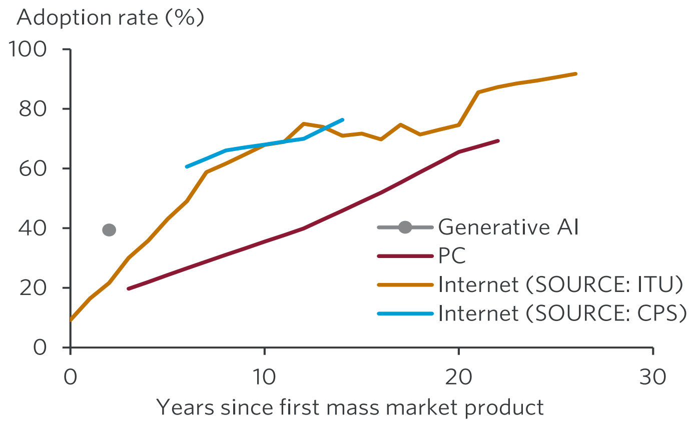
Source: StatCan, BEA, CIBC

Chart 2: US manufacturing becoming more capital intensive



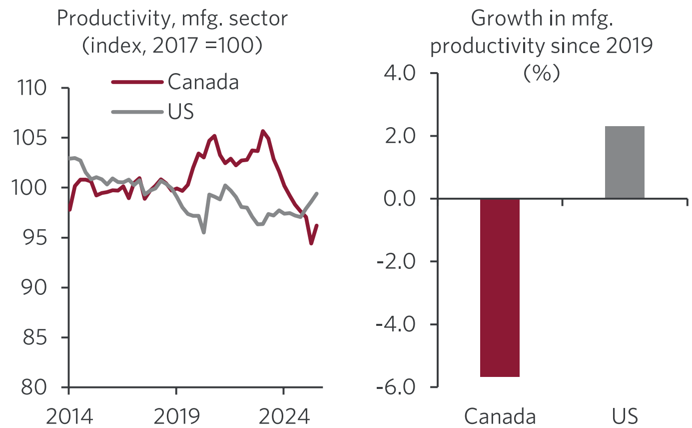
Source: FRED, CIBC

Chart 3: Rapid AI adoption



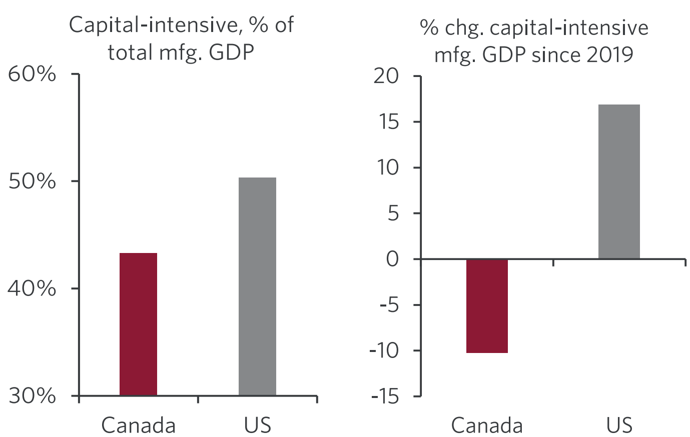
Source: St. Louis Fed, CIBC

Chart 6: Higher capital-intensity in US has helped cushion productivity



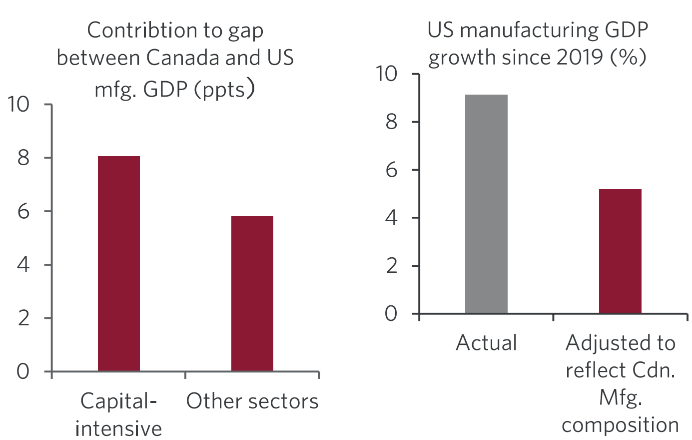
Source: StatCan, BEA, CIBC

Chart 4: Canadian manufacturers' less capital intensive (l), and have underperformed in those sectors (r)



Source: StatCan, BEA, CIBC

Chart 5: Performance gap still exists when controlling for differences in sub-industry mix



Source: StatCan, BEA, CIBC

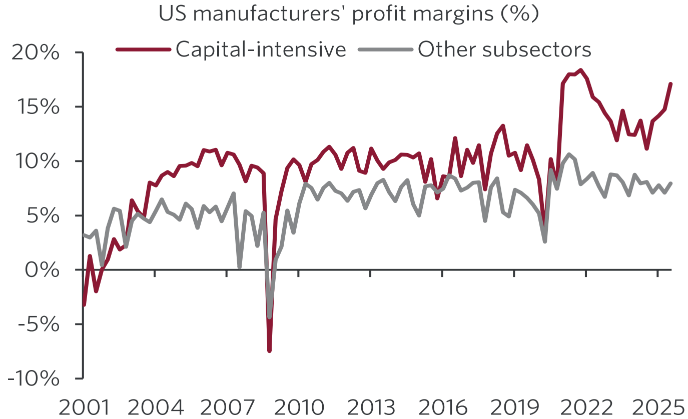
industries to non-capital-intensive industries actually falling since 2019. This trajectory is working to widen an already wide gap between US and Canadian manufacturing capital intensity — reflecting not only the natural composition of Canada's manufacturing base, but also the fact that, in many cases, highly capital-intensive sectors in Canada are not as capital-intensive as their US counterparts (Chart 4).

No surprise then that capital-intensive manufacturing industries contributed no less the 8%-pts. to the performance gap since 2019. In fact, we estimate that the difference in the industrial composition of the manufacturing sectors played a significant role in the growth and productivity gap. While US manufacturing GDP has risen by a cumulative 9% since 2019 — that performance would have been only 5% if US manufacturing had the industrial composition of Canada. In other words, the difference in the industrial composition between the two sectors explains a notable share of the performance gap since 2019 (Chart 5).

That dynamic of course is a significant factor behind the huge and rising productivity gap between the two sectors. Since 2019, US manufacturing productivity has increased by over 2%, but in Canada it has fallen by over 5% (Chart 6). The capital-intensity induced improvement in productivity also means that the current gap between GDP activity and labour market performance will continue to widen, with the Fed likely to pay increasingly more attention to manufacturing production as opposed to net job creation in the sector. In Canada, that shift in focus will be much slower.

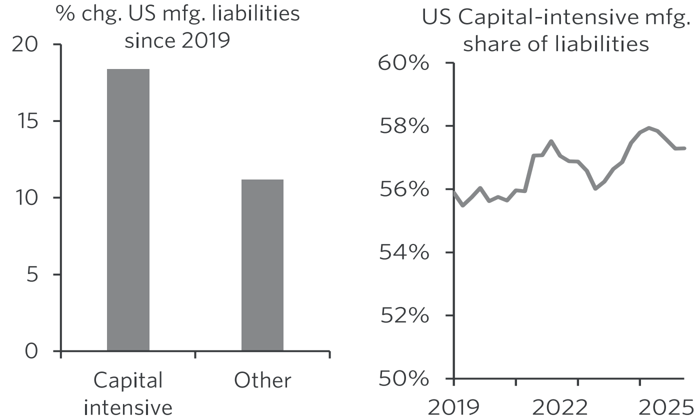
What's more, as illustrated in Chart 7, capital-intensive industries see profit margins that are 9%-pts. higher than other manufacturing sub-sectors. It's no surprise then that the profitability gap between the US and Canada has been

Chart 7: Capital-intensive manufacturers enjoy higher profit margins in US



Source: Census Bureau, CIBC

Chart 9: Capital-intensive manufacturers rely more on debt



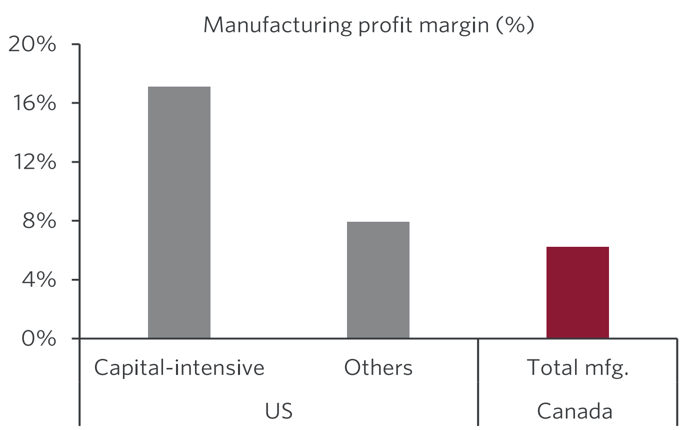
Source: Census Bureau, CIBC

widening. In fact, profit margins for Canadian manufacturers are on average lower than they are for their low-intensity US counterparts (Chart 8).

Note, however, that the rapid increase in US capital-intensive manufacturing activity was financed largely by debt. Since 2019, liabilities of capital intensive firms have risen by 18%, compared to 11% among low capital-intensive companies, bringing their share in total manufacturing liabilities to 57% (Chart 9). That increased sensitivity to debt might not be an issue at the moment with the Fed likely to ease policy in the coming quarters, but it might generate a mild headwind after that — certainly relative to less indebted Canadian manufacturing firms.

There is little doubt that capital intensity in manufacturing will continue to rise in the coming years. Forces such as deglobalization, just-in-case inventories, and tightening labour markets will force firms to exchange labour with capital, and the new technological revolution that is upon us will work to dramatically accelerate that process. Canadian manufacturing CEOs cannot ignore this reality. It's hard to see Canadian manufacturing closing the gap with the US anytime soon. But a comparatively lower sensitivity to interest rates, and the fact that the current low rate of capital intensity in Canadian manufacturing suggests plenty of low hanging fruit available, might lead to improved momentum in production in the coming years.

Chart 8: Manufacturing profit margins in Canada are lower than US



Source: StatCan, Census Bureau, CIBC

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