OBSERVATION
TD Economics

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CANADA'S CONSTRUCTION SECTOR FLEXES ITS ECONOMIC MUSCLE

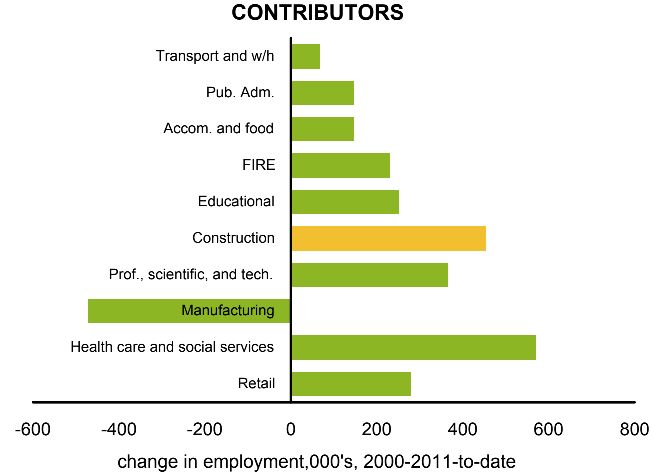
Highlights

- The construction industry was the second fastest growing industry over the last decade. The sector, which accounts for about one tenth of Canadian GDP, directly boosted total economic growth by a sizeable 0.5 percentage points per year on average, more than double its prior 20-year average. What's more, nearly one million direct and indirect jobs have been created due to the building boom over the past decade.
- Nonresidential construction helped provide the largest lift to real GDP growth, while residential building experienced the largest gains in employment.
- 2011 likely marked a transition into a period of more moderate pace of building. Over the next few years, slowing housing demand and an overbuilding in the Canadian condo market are likely to weigh on residential building construction. Government focus on deficit reduction also implies a slower pace of spending on infrastructure. The good news is that healthy business balance sheets, a decent profit outlook and a number of tax incentives will support continued strength in nonresidential building.
- While the economic thrust from construction will likely moderate significantly over the medium term, the sector is expected to continue to positively contribute to economic and job growth.

The construction industry was the second fastest growing industry over the last decade. The building boom – comprised of both non-residential and housing development – has delivered major economic and job benefits to Canadians over the past decade. In fact, 400,000 direct jobs have been created since 2002 – a tally surpassed by only the health care and social services sector. If we consider knock on effects such as additional consumer spending from increased employment and the benefits that quickly cascade into other industries that offer support to building activity (i.e. suppliers, creditors, and real estate services) the employment gains are estimated at 800,000. In terms of direct real GDP impacts, the construction wave has alone lifted average annual real GDP growth by one half a percentage point over the past decade, accounting for a quarter of Canada's overall growth rate. Not bad for a sector making up just less than 15 per cent of the economy.

While the industry's performance over the last decade has been astonishing, some of the recent strength is likely to taper off in the coming years. Indeed, it is our view that 2011 marked the transition into a period of more moderate building activity. A slowing in the Canadian housing market and an overbuilding

CHART 1: CANADA'S TOP TEN EMPLOYMENT CONTRIBUTORS



Source: Statistics Canada/Haver Analytics

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TABLE 1: CANADIAN CONSTRUCTION INDUSTRY'S ECONOMIC CONTRIBUTION									
	Share of Real GDP			Average Annual % Change			Average Annual Contribution to Real GDP growth (%)		
	2000	2011	2015	1980-2001	2002-2011	Forecast 2012-2015	1980-2001	2002-2011	Forecast 2012-2015
Total	10.8	13.7	12.8	1.3	3.3	0.6	0.2	0.5	0.1
NonResidential	6.1	7.7	8.1	1.0	3.3	3.4	0.1	0.3	0.3
Government	1.4	2.8	2.5	1.6	7.2	0.1	0.0	0.2	0.0
Private	4.6	4.9	5.5	0.9	1.8	5.1	0.0	0.1	0.3
Residential	4.7	5.9	4.7	2.2	3.5	-3.5	0.1	0.1	-0.2
New Homebuilding	2.3	2.5	2.5	2.2	5.6	-3.2	0.1	0.1	-0.1
Renovations	1.6	2.8	2.2	3.0	5.9	-3.8	0.1	0.1	-0.1

Source: Statistics Canada/Haver Analytics. Forecast by TD Economics as of November 2011

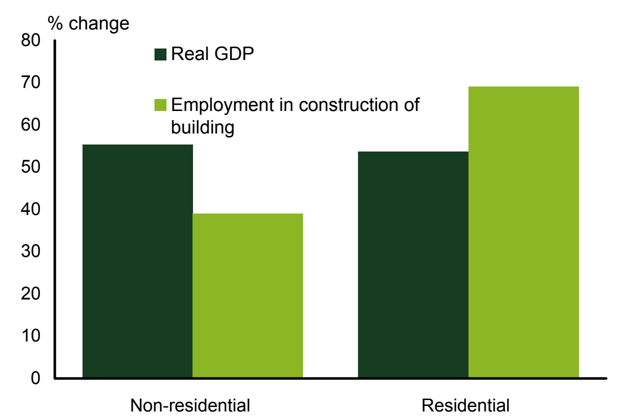
in the condominium market is expected be the main forces for a moderation in residential building, while government deficits are likely to lead to a cooling in public infrastructure spending over the next five years. The good news is private nonresidential investment should help offset some of the weakness stemming from other areas. Overall, we expect the contribution to output and jobs from construction to ease over the next five years, but for growth to remain in positive territory.

Nonresidential structures led growth…

Most areas of construction boomed over the last decade, but the strongest economic contribution came from growth in nonresidential structures. This area accounted for about two fifths of the growth impact and 160,000 net new jobs. Chart 2 indicates that most of the last decade's gains were concentrated in the building of commercial property, like office buildings and malls. Strong household spending in combination with declining vacancy rates and rising rents in commercial office markets spurred gains in retail and office space, respectively. The strength in commercial property development helped offset weakness stemming from investment in industrial units (for example, factories). Rising commodity prices and thriving resource development benefitted industrial and engineering building activity as well as providing large knock-on effects to other areas of the economy. However, the resource sector is still quite small when compared to manufacturing as a share of overall economic activity and business spending. As such, industrial investment declined heavily through the last decade as a lofty Canadian dollar strained manufacturing profits.

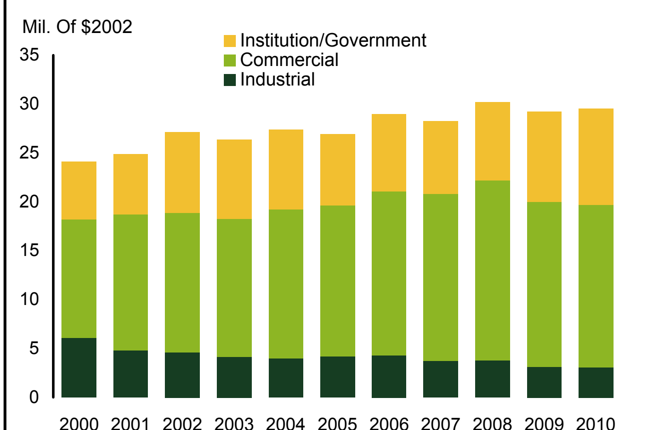
Private-nonresidential construction activity suffered a

CHART 2: EMPLOYMENT AND REAL GDP GROWTH FROM 2000 TO 2011



Source: Statistics Canada/Haver Analytics

CHART 3: NONRESIDENTIAL CONSTRUCTION BY TYPE



Source: Statistics Canada/Haver Analytics major setback during the 2008-09 recession. Still, the federal and provincial governments took up the slack through sizeable infrastructure stimulus programs. It is estimated that this stimulus helped to generate an average of about 1.3 per cent per year in 2008 and 2009 as well as some 82,000 direct and indirect jobs. Accordingly, total nonresidential building activity remained relatively stable over this more challenging period.

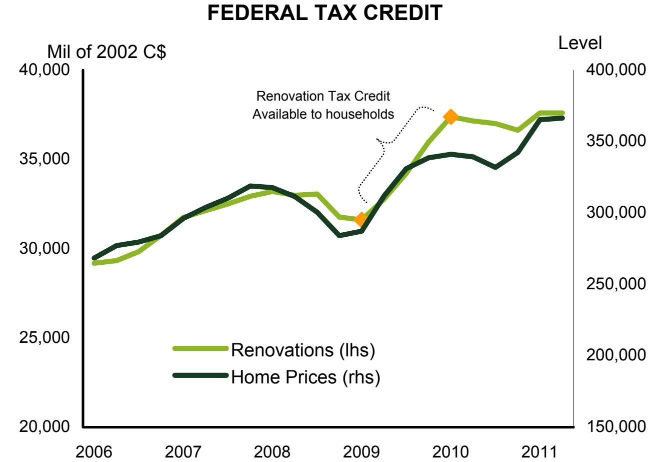
…while residential construction led job gains

While the economic contribution from nonresidential building was the largest, the employment gains from residential building construction over the last decade were almost double that from the nonresidential sector (see chart 2). Both renovations and new homebuilding benefited from a large upswing in demand for housing and home prices. New homebuilders responded by increasing production. Meanwhile, renovators were kept busy, as those who purchased an existing home upgraded and improved the look of their home to suite their tastes. Even when the recession hit, the downturn in residential building was short-lived as record low interest rates drove a sharp rebound in late 2009 and early 2010. The real kicker was the introduction of the Government of Canada's renovation tax credit. While the credit applied to renovations completed between January 2009 and February 2010, the benefits really gained traction in late 2009. We estimated that the renovation tax credit increased renovation spending by $4.5 billion in 2010, or 6% of construction activity.

Strength was largely wide-spread across regions

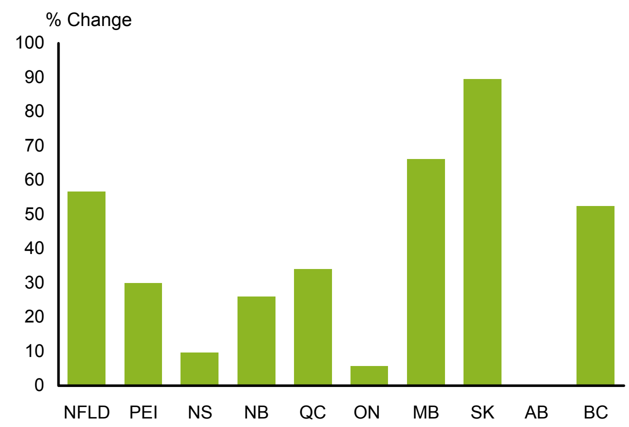
Regionally, the strength has been broadly based with

CHART 4: RENOVATIONS GET LIFT FROM FEDERAL TAX CREDIT



Source: Statistics Canada. Haver Analytic

CHART 5: GROWTH IN CONSTRUCTION OUTPUT FROM 2002-2010



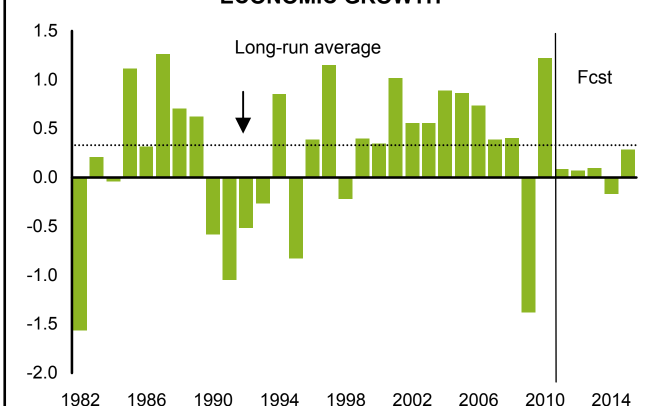
Source: Statistics Canada/Haver Analytics

the exception of Nova Scotia and Ontario. Still, the leading provinces have been British Columbia, Saskatchewan and Manitoba underpinned by a robust resource sector. Prior to the recession, construction activity in resource rich Alberta led the pack. However, since the recession hit in 2008/2009, housing market activity has been soft in Alberta and construction is yet to pick up significantly. Residential construction in Ontario was also quite robust over the last decade. However, the province was hard hit by the manufacturing slump that began in 2002 – the time the Canadian dollar began its ascent toward parity. The drag from nonresidential construction offset the strength from residential building in Ontario.

2011 marks a transition to a slower pace of construction growth

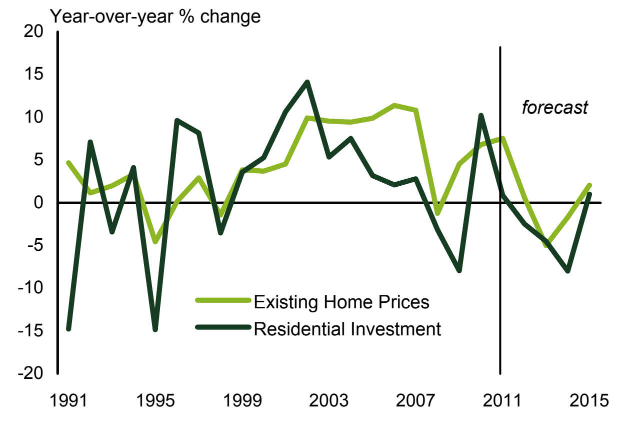
The contribution from construction to economic growth

CHART 6: CONSTRUCTION'S CONTRIBUTION TO ECONOMIC GROWTH



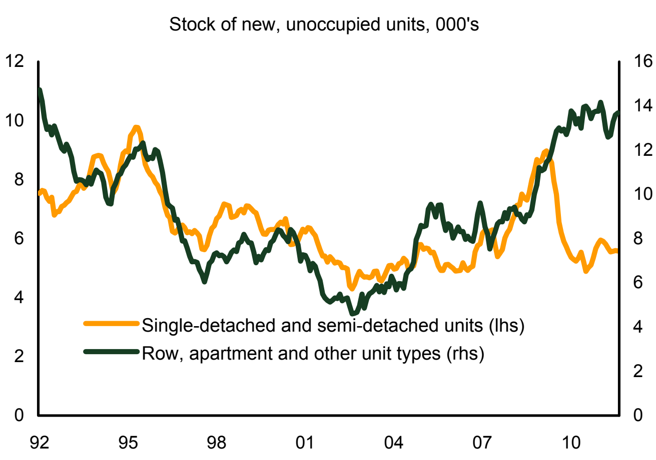
Source: Statistics Canada/Haver Analytics. Forecast by TD Economics as of November 2011

CHART 7: COOLING HOUSING MARKET TO WEIGH ON RESIDENTIAL BUILDING



Source: Statistics Canada, Haver Analytics, Forecast by TD Economics as of November 2011

CHART 8: LARGE INVENTORY OF UNSOLD CONDOS A CONCERN



Source: Statistics Canada

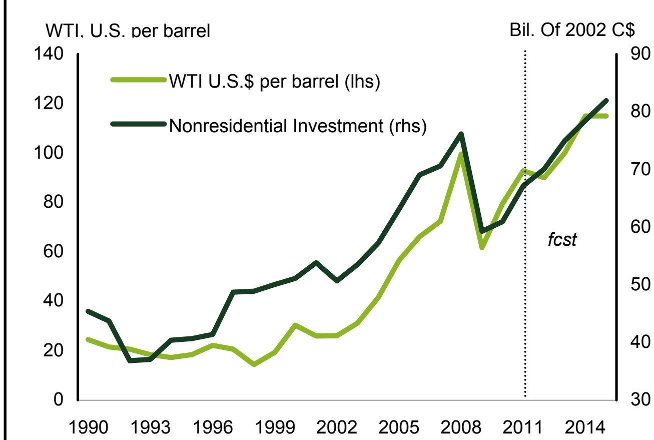
across the country has remained relatively healthy in 2011, led by condo building and nonresidential investment. Strength in certain areas of construction has started to ease, but that more reflects the end of government stimulus programs than anything else. Nonetheless, even as these temporary factors fade, 2011 is likely to mark a transition year as we move into a period of more moderate, but sustainable construction growth over the next three years.

On the residential front, the outlook for continued low interest rates and favourable affordability is likely to keep new home demand and home renovations spending elevated in 2012. Despite this strong outlook, homebuilding activity is likely to moderate from this year's pace in light of rising land costs and eroding economics of development. An even bigger risk surrounds the increasing trend of new home inventories, mostly condos. The number of newly completed but unoccupied homes has been at a decade high since mid-2009, and are just shy of levels experienced post the 1990's housing crash. Looking at the number of units under construction (see chart 8) points to a growing glut of unsold inventory of condominiums. These factors, combined with an outlook for rising interest rates in 2013 and into 2014, will lead to a moderate drop in residential building activity and related jobs in the 2012-15 period. Our forecast is for an average annual decline of 3.5% in residential building over that period.

Government spending on infrastructure will likely also slow. Governments at all levels are tackling significant deficits. The deficit challenge is most significant at the federal level and among central and eastern Canadian provinces. In light of increased restraint, government capital budgets will not be immune to cutbacks. With the end to stimulus, the Federal Government plans to spend just a third on infrastructure in the fiscal year 2011/2012 than what was spent in 2010/2011. Over the medium term, Government expenditure plans embedded in budgets imply flat spending on infrastructure until 2016.

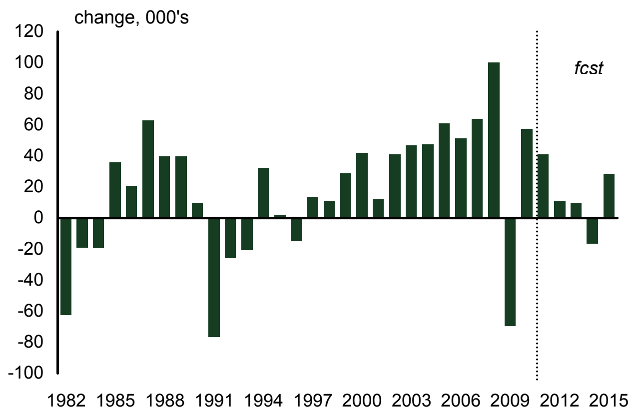
Still, we expect the economic contribution of the overall construction sector to remain positive, owing to ongoing solid growth in private nonresidential activity. There is no doubt that growth in business spending has been strong over the last year, but there could be more. Many Canadian businesses have held back from making large purchases in the wake of economic uncertainty. Once the economic clouds dissipate – likely in 2012 – the environment in Canada is ripe for continued spending among businesses. First, businesses have been shoring up their balance sheets by stashing

CHART 9: NONRESIDENTIAL INVESTMENT TO REMAIN A BRIGHT SPOT



Source: Statistics Canada, WSJ, Haver Analytics. Forecast by TD Economics as of November 2011

CHART 10: CONSTRUCTION EMPLOYMENT TO MODERATE



Source: Statistics Canada/Haver Analytics. Forecast by TD Economics as of November 2011

cash and are now sitting on record levels of it. Canadian businesses are sitting on $9 billion worth of financial assets , up 21% since the economic crisis hit in 2007. This is cash that can be deployed for investment purposes. Second, lofty commodity prices, while off their decade highs, are still highly profitable for the resource sector. Healthy profitability is expected to keep investment in resource rich economies strong. Third, a number of government initiatives – such as the introduction of the harmonized sales tax in Ontario and corporate income tax rate reductions at the federal and provincial level – are expected to attract business investment in Canada. These factors spell good news for the nonresidential construction industry. Meanwhile, plans for U.S. big name retailers to enter the Canadian market will help the continued expansion of retail space. Our view is that spending on nonresidential infrastructure will rise by an annual average of 6% over 2012-2015.

Putting it all together, the contribution from the construction industry will likely slow, but remain positive over 2012-2015. Overall, construction output will likely contribute on average 0.2 percentage points per year to economic growth over 2011 to 2015. Consistent with this outlook, job gains from the industry will likely be modest and in the range of 10,000 per annum. The construction industry will still account for one-in-eight of the total jobs created in Canada over the next three to four years.

Bottom line

The Canadian construction activity was a major contributor to economic growth over the last decade. The pace of construction activity over the last decade was unsustainable, and led to a number of excesses that will need to be worked off. Governments have to now grapple with large deficits and the housing market has to work off a high level of unsold inventory. On the bright side, strong business investment in nonresidential structures, led by a healthy profit environment, should help support a modest pace of building activity over the next three years. As such, our forecast for a annual average 3.5% decline in residential construction, a flat growth profile for government expenditures and an average annual growth rate of 6.0% for nonresidential construction suggest overall construction activity will grow by 1.7% over that time horizon.

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