



TD Economics

Topic Paper

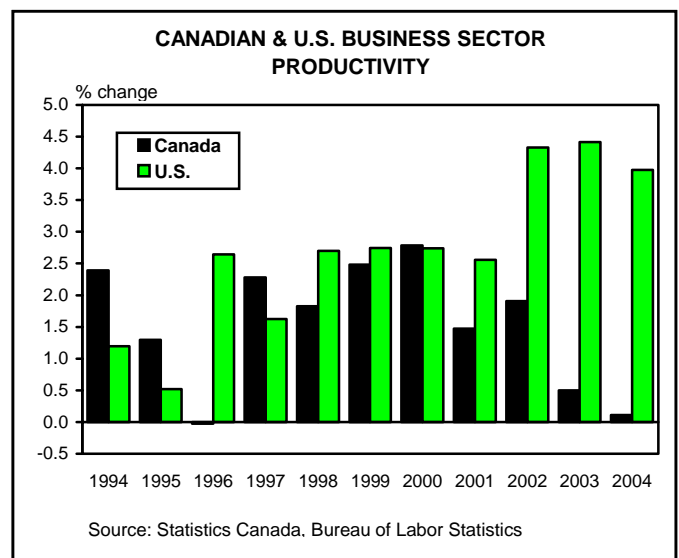
June 15, 2005

WHO'S TO BLAME FOR CANADA'S PRODUCTIVITY WOES?

Canada's bleak record in labour productivity (output per hour worked) is well known. Indeed, since 2001, the Canadian economy has registered a cumulative increase of just 2.5 per cent in productivity growth compared to a 15.9 per cent gain in the United States. This is a staggering difference considering that the U.S. also experienced a recession in 2001 that Canada avoided. More troubling, Canadian productivity growth has slowed to a rate of just 0.1 per cent in 2004, at a time when Canada's large export-intensive industrial landscape is facing significant erosion in international competitiveness due to a stronger currency. Moreover, a lack of productivity growth could also imply a slower rate of potential economic growth in Canada. And, this has raised some fears that Canada's economy could be even closer than the U.S. to tripping over capacity constraints resulting in potential inflationary pressure. However, a deeper inspection of Canada's aggregate productivity record reveals that the lack of recent growth is largely the result of the offsetting performance of various sectors within the economy. As such, Canada's productivity situation may not be as grim as it first appears.

Trade-oriented sectors are working smarter

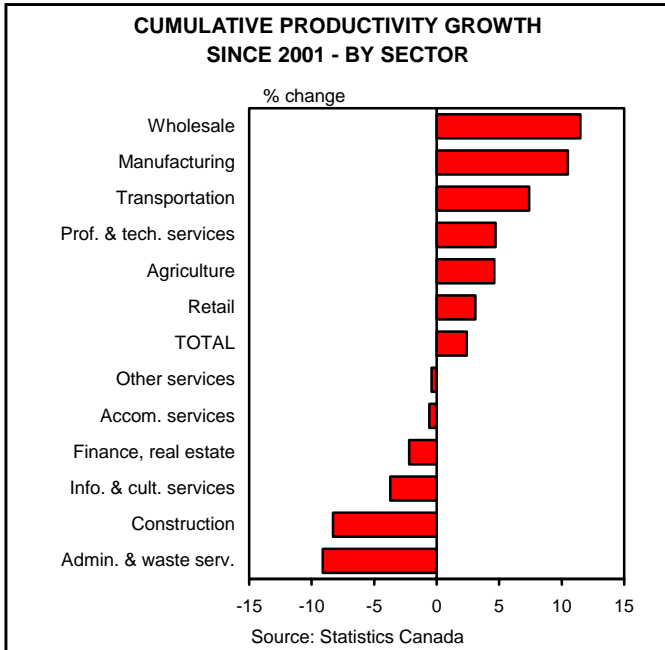
Conventional economic wisdom would assume that the adjustment process to a stronger currency would manifest itself in sectors that are more heavily exposed to trade.¹ That's because those sectors would risk losing market share to cheaper international competitors if they did not improve their productivity. To that end, the data do reveal that trade-oriented sectors in Canada's economy have been reacting to the competitive pressures of a higher currency, growing their productivity by about 5 – 12 per cent since 2001. In particular, manufacturing (the largest trade-ori-



ented industry in relation to its size in Canada's economy) has seen a cumulative productivity increase of nearly 11 per cent since 2001 with a strong 2.5 per cent increase registered just last year.

At first blush, manufacturers could have accomplished these productivity gains by improving the way its existing workforce utilized available resources. While that might have been the case prior to the loonie's ascent in early 2003, near-record high levels of capacity utilization brought on by surging global demand along with probable write-offs of uneconomic capacity because of relative price changes suggest that there has been little efficiencies left to exploit.

Consequently, manufacturers have begun to step up investments in machinery and equipment and appear to have been incorporating a greater mix of capital in the production process. As a result, since 2003, they have been able to boost their real output by an average annualized

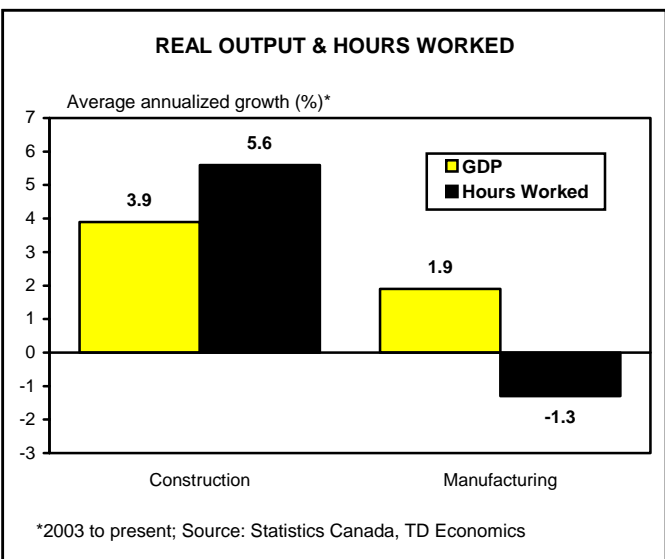


dollar, the data reveals that domestically focused sectors have not. And since they have largely offset most of the gains being made in trade dependent sectors of the economy, they are largely to blame for Canada's poor productivity record.

However, the biggest perpetrator (in relation to its size in the economy) appears to be the construction sector. With low interest rates stoking housing demand, real construction output has increased by an average annualized rate of about 4 per cent since 2003. However that output was largely driven by increased labour with hours worked in the sector growing by an annualized rate of almost 6 per cent. The result is an abysmal record of productivity growth, slumping by 4.3 per cent in 2004 on the back of successive declines in the previous two years.

So why has construction fared so badly in productivity, especially over this recent housing boom? One explanation is that when the sector is expanding rapidly, improved profitability allows inefficiencies to develop. Indeed, the decline of capacity utilization rates in construction since 2001 could imply this.

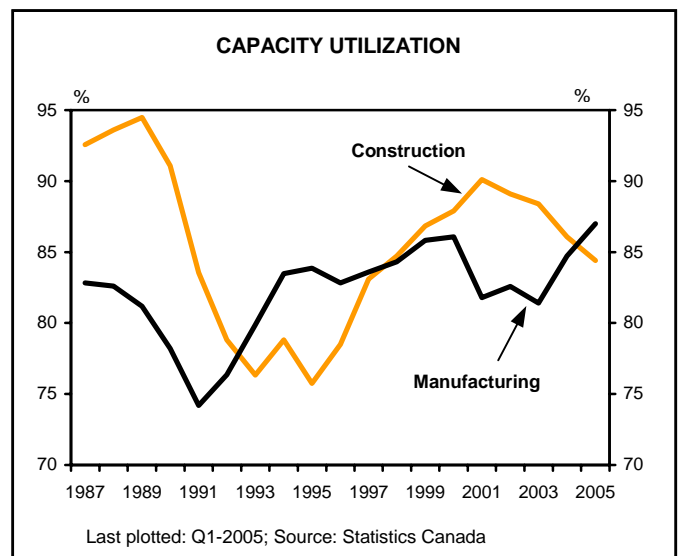
But this decline in capacity utilization since 2001 seems at odds with anecdotal reports of homebuilders facing considerable stress given surging new housing demand. One way of quickly reconciling this paradox is to acknowledge that only residential construction has boomed over the past few years. On the other hand, non-residential construction activity has remained stuck in the doldrums since the implosion of the tech bubble in late 2000 and is only recently showing glimpses of improvement. And since non-



rate of about 2 per cent while at the same time reducing factory hours by 1.3 per cent. Keen on pursuing further improvements in productivity, manufacturers intend to increase real spending on machinery and equipment by more than 20 per cent in 2005. And despite all the upheaval from a stronger Canadian dollar, manufacturers managed to increase profits by more than 30 per cent last year, giving them sufficient means to further pursue these improvements to capital spending in 2005.

.....while domestically focused industries are not

While trade-oriented sectors of Canada's economy have been forced to work smarter because of a higher Canadian



residential construction tends to be somewhat more capital-intensive than homebuilding, excess capacity in the capital stock of construction could be more indicative of conditions in that side of the sector.

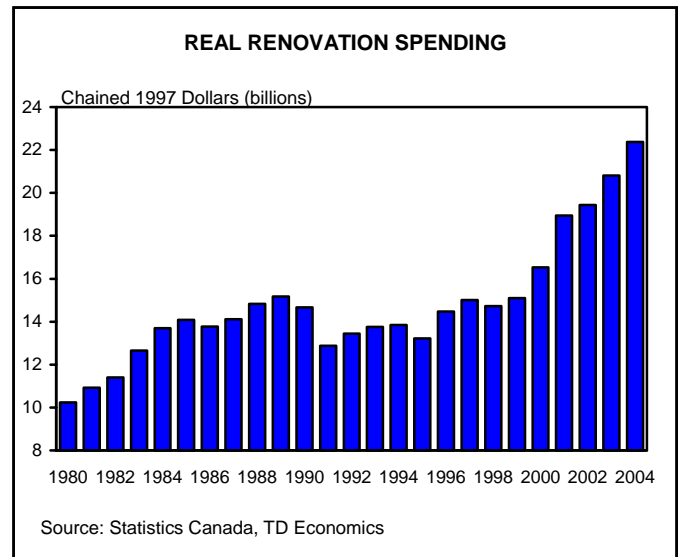
A more intriguing, and possibly more plausible reason, for the construction sector's weak productivity record could be due to measurement problems. In particular, potential biases could exist in the estimate of construction price indexes resulting in a misrepresentation of real economic output in the sector. That is conceivable given that there have been substantial quality changes in housing over recent years and especially during the current housing boom (i.e., greater energy efficiency of homes, the inclusion of appliances etc.) that are difficult to capture in a price index given the heterogeneous nature of housing itself.²

In addition, the presence of growing underground activity could be also distorting construction productivity statistics. That's because workers have a greater incentive to underreport income when filing tax returns than to underestimate the hours they have worked when responding to the Labour Force Survey. Indeed, average annual compensation growth in the construction industry is estimated to have risen by a meager 0.7 per cent last year despite an extremely tight labour market. On this basis, real output measures for construction could be biased downward in relation to the amount of labour used.

Interestingly, this downward bias could have been intensified since the current housing boom began in 2001 given the growing role of housing renovation activity in this cycle. That's because a recent study found that most of the construction sector's underground activity takes place within this segment.³ And over the last few years, the renovation industry has grown to account for nearly 6 per cent of real GDP growth, in comparison to its 2 per cent share of the overall economy.

Meeting the competitive cost challenge

The lack of labour productivity gains in construction and some of the other domestically oriented sectors, combined with the higher Canadian dollar, is largely responsible for last year's 8.5 per cent gain in unit labour costs in Canada (as measured in US dollars.) Indeed, weak productivity growth in the construction sector resulted in a whopping 5.2 per cent rise in that sector's unit labour costs



(measured in the home currency) in 2004. In contrast, total business sector unit labour costs in the United States rose by less than one per cent. As most economists would note, this situation is troubling since it represents substantial erosion in international competitiveness for Canadian industries.

But if the construction sector is in fact holding back some of the overall productivity growth in Canada, the complete picture, at least from a competitive point of view may not be as dire as it appears. That's because this sector's exposure to foreign competition in the domestic market is close to nil. Consequently, rising unit labour costs in construction would have very little implication on Canada's ability to compete internationally. It would, however, have some impact on the industry's profitability and/or hurt domestic new homebuyers as those costs would more than likely be passed through into the price of a new home. But since domestic interest rates have remained near historical lows, that type of pass through has had little negative impact on housing affordability as yet. Furthermore, if measurement problems are clouding construction's productivity statistics, then the magnitude of the increase in unit labour costs might also be suspect.

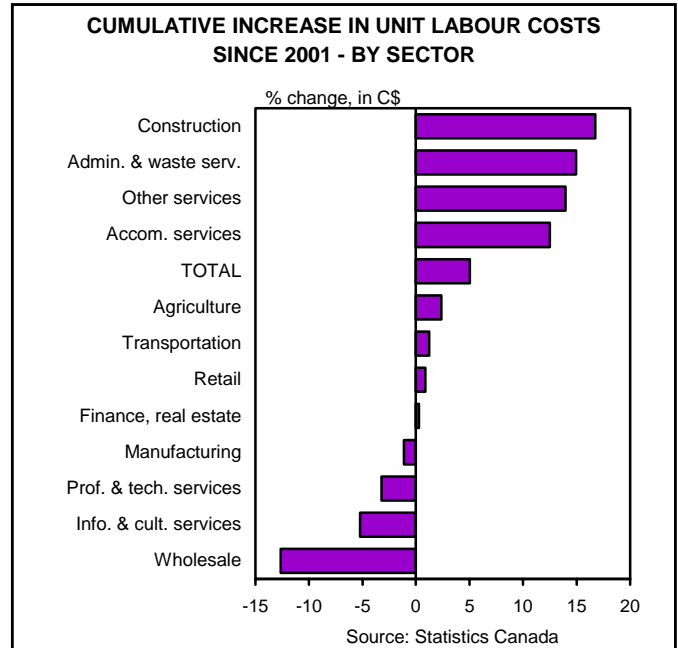
Meanwhile most trade-oriented sectors have indeed been reigning in their unit labour costs since 2001. In particular, the manufacturing industry experienced a 2.7 per cent reduction in unit labour costs during 2004 thanks mostly to improving productivity (whereas compensation growth in the sector was essentially flat.) In contrast, unit labour costs for U.S. manufacturers declined by just 0.7

per cent. To this end, it appears that Canadian manufacturers, but also other trade-oriented sectors of the economy, are adjusting to the new realities of a higher loonie by reducing their costs in order to remain internationally competitive.

A note of caution

Still, an important caveat should be made. Specifically, it would be presumptuous to believe that weak productivity in the construction sector is purely a Canadian phenomenon. Indeed, many U.S. economy watchers (including Alan Greenspan himself) have indicated that the U.S. construction sector also lags behind its national productivity statistics as well. Greenspan attributes this to a high degree of custom homebuilding that might make it difficult to achieve significant productivity gains in construction despite ongoing technological advances in other areas of the economy.

In this regard, Canada's poor productivity record vis-à-vis the U.S. cannot be blamed solely on the construction sector. Consequently, other Canadian industries, especially those that have a high exposure to net trade must continue to improve their productivity in order to close the productivity gap with the United States and to effectively compete in the global marketplace. But even other domestically focused industries, which admittedly may not be



under the same type of currency-related pressure to improve productivity, should not be complacent. That's because weak productivity is ultimately one of the biggest roadblocks to improving Canada's standard living. The good news is that Canadian businesses are intending to make further investments in capital equipment in 2005, suggesting that they are at least planning on moving in the right direction.

Carl Gomez, Economist
416-982-2557

Endnotes:

- ¹ For a complete analysis of net trade exposures by industry see our 2005 Industrial Outlook at www.td.com/economics
- ² Some analysts have suggested that the strong increase in relative valuation models of housing over the last few years confirm the existence of a housing bubble. However, if there has been strong qualitative changes in the underlying value of housing over this period, then the recent rise in relative valuations could be justified on these grounds.
- ³ See O'Grady, John, Greg Lambert and ARA Consulting Group (1998), *The Underground Economy in Ontario's Construction Industry: Estimates of its Size and the Revenue Losses to Government and the WISB*

The information contained in this report has been prepared for the information of our customers by TD Bank Financial Group. The information has been drawn from sources believed to be reliable, but the accuracy or completeness of the information is not guaranteed, nor in providing it does TD Bank Financial Group assume any responsibility or liability.