PERSPECTIVE

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BUSINESSES ARE PULLING THEIR WEIGHT, BUT MORE CASH COULD BE PUT TO WORK

A recent comment by Bank of Canada Governor Carney that businesses are sitting on piles of cash to the tune of $526 billion, which represents dead money, has sparked a debate about whether businesses are pulling their fair weight in driving economic growth. As with most controversies, the truth is far greyer than black and white.

Businesses have been a major contributor to the economic recovery. Since the turning point in mid-2009, business investment in structures and equipment has increased by a cumulative 27%, which represents a strong average annualized quarterly pace of 9.5%. It is worth noting that business investment remains only 2.3% below its pre-recession peak, while corporate profits are still 20% off their 2008 high. In addition, the share of profits that businesses use to invest in structures and equipment has been running at close to its historical norm during the recovery. If there is a criticism, it would be that structures have been a bigger share and investment in equipment has been a lesser share. Private sector hiring has also been strong during the recovery. Of the 721,700 jobs created since mid-2009, the private sector has accounted for 80% of the net new positions.

It is true that firms have increased their holdings of cash, but calling all of it dead money is overstated. All firms hold cash to manage inventories and meet other short-term financial commitments. The low interest rate environment has also encouraged businesses to hold more cash, since the opportunity cost of cash relative to bonds or other instruments has declined. Moreover, volatile financial market conditions have encouraged holdings of cash. Indeed, the financial crisis showed the value of holding cash in instances where credit conditions become impaired. In 2008/2009, liquidity became king. These points can be captured by the fact that there has been a decline in non-cash holdings of financial assets by corporations, particularly a decline in short-term financial assets for which cash could be a substitute.

There is no question that some of the increase in cash reflects reduced business confidence and greater risk aversion. On an individual firm basis, this was a rational decision. Europe is dealing with a financial crisis that could plunge the global economy back into recession. The U.S. economy is weak and there is considerable regulatory and fiscal uncertainty. Emerging market economies are in the midst of a slowdown, which has negatively impacted commodity prices and global demand. There are heightened geopolitical tensions with Iran that pose an oil shock risk. I could go on, but one gets the point that this is a highly uncertain and risk-filled environment. The problem is that while it can be rational for each individual firm to hold more cash, when all choose to do so, it creates a major economic impediment.

Having said all of the above, the Governor's comments are constructive and beneficial. They also echo a similar theme made by Finance Minister Flaherty suggesting that the government has done its part in creating a more favourable environment for Canadian businesses, and now the private sector must step up to the plate. One can understand the frustration of policymakers, as they have provided every incentive for businesses to invest and grow. The marginal effective tax rate on capital has plunged in recent years, reflecting lower corporate tax rates, accelerated depreciation allowances, the elimination of capital taxes and other policies. The Bank of Canada has kept borrowing costs incredibly low and the strong Canadian dollar has made it cheaper to invest in imported machinery and equipment. The corporate balance sheets clearly show that there is the financial capacity for increased investment. So, while business investment has been solid and a key contributor to economic growth, the point is that corporations could have done even more. Given the incentives, policymakers believe that investment in machinery and equipment should not have been just robust, it should have been booming.

The challenge is that firms make investment decisions on the basis of future demand for their goods and services, and expectations on this front are subdued. The outlook is for only modest domestic demand and export growth. Profit growth has also been slowing and looks likely to rise at a mid-single digit annual pace in the coming quarters.

The underlying message from policymakers is that despite near-term risks and prospects, Canada must up its game. We have a competitiveness challenge and a problem with exceedingly poor productivity growth, which could impede Canada's prosperity even when international headwinds start to ease. It has long been acknowledged that part of Canada's productivity struggle has been under investment relative to its international peers in productivity-enhancing machinery and equipment. Canada needs to increase its capital stock, thereby raising the ratio of capital to workers. By doing so, Canada's medium-to-long term economic growth rate would be increased, which would ultimately lead to a higher standard of living for Canadians and help governments to rebalance their finances.

The conclusion I reach is that Canadian businesses have been a major contributor to the economic recovery and have certainly carried their fair share of the economic weight. The suggestion that there is $526 billion of dead money is overstated. Nevertheless, the debate and discussion that were sparked by the comments are, in fact, very useful. It provides an opportunity to promote increased investment and encourage prudent risk taking in a very uncertain environment. If the comments by the Governor and the Finance Minister lead executives and boards of directors to question the level of cash holdings, then the debate has been impactful. The simple truth is that, at the economy-wide level, businesses under invested prior to the recession and they cannot let the prevailing risks paralyze them from investing in the coming quarters. They have to build for the future. If more of the cash on balance sheets is put to work, it would be to the benefit of the economy and the nation. So, let the debate rage on.

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