Bank Financial Group

Special Report

November 16, 2009

TD Economics
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HIGHLIGHTS

- While the Canadian economy has turned the corner, competitive pressures will persist during the rebound and the most productive firms will survive and thrive.
- A soaring loonie is a strong headwind to export competitiveness, and increases competition from imports in the domestic economy.
- Canadian firms must adapt by improving their productivity through investing and innovating.
- Investment in high-tech capital complements higher skills and facilitates better business processes, boosting productivity by getting more output for each hour worked.
- The currency appreciation coincides with stagnation in U.S. M&E prices, meaning that importing new equipment is increasingly cheap.
- The combination of attractive borrowing costs, bargain prices on high-tech capital goods, favourable tax changes, and a coming rebound in demand represents a unique opportunity on which Canadian firms should capitalize.

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# INNOVATION AND NEW INVESTMENT REMAIN KEY TO BUSINESS SUCCESS

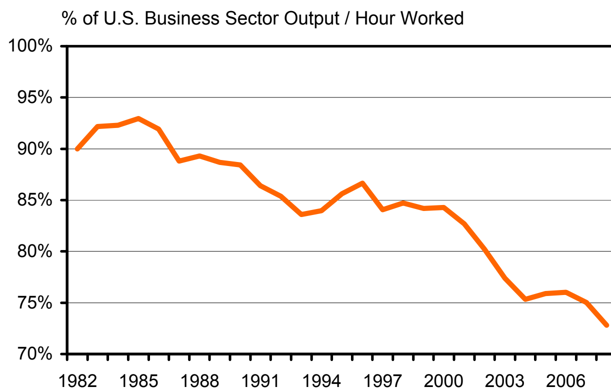
An economic recovery has taken hold in Canada, but the pace of economic growth will remain subdued. That means businesses will continue to face a fiercely competitive and challenging environment. Exporters will struggle with a strong Canadian dollar and only gradually improving U.S. demand. Domestic companies will face more competition from foreign imports from countries with lower labour costs and/or weaker currencies. And, domestic demand will likely prove moderate in 2010 and 2011. Given this outlook, businesses must consider every possible option to boost efficiency, constrain costs and improve margins. Additional investment in machinery and equipment (M&E), particularly the deployment of new innovations, could prove a key ingredient for success. The good news is that a host of factors make now a good time to make such investments. Borrowing costs are low, credit is accessible, profit growth will gradually recover and the strong Canadian dollar is making it cheaper for firms to purchase imported equipment. Greater investment in new capital would reap benefits for both individual companies and the economy as a whole. Indeed, additional investment could help to address Canada's abysmal productivity performance in recent years, which is one of the country's most pressing problems.

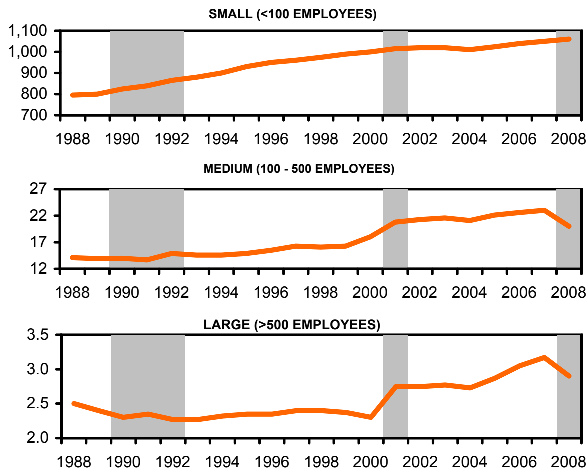
## Economic recovery doesn't mean clear sailing

While economies worldwide are seeing positive growth, the recovery will proceed at a subdued pace – especially for major developed economies. The U.S. recovery will be dampened by still-mending household balance sheets and the ongoing deleveraging and recapitalization of many financial institutions. So, while U.S. demand for Canadian exports will improve, the increase will only gradually recover the ground lost during the recession. Moreover, Canadian export competitiveness will be hampered by a strong Canadian dollar, which is expected to reach parity in late 2009 or early 2010.

Canada severely lags our international peers in productivity and this gap is a major hindrance when competing in export markets, since the most productive producers are most able to win market share and grow their business. As of 2008, Canada's business-sector productivity had fallen to 72% of the U.S. business sector output per hour. During the past decade, slumping productivity growth rates in the manufacturing and resource sectors were the largest contributors to this growing overall productivity gap. Moreover, productivity of the Canadian manufacturing industry grew much slower during the last decade than did that of U.S. manufacturing.

Canada's still-widening productivity gap with the U.S. points to an equilibrium value of the Loonie somewhere between US$0.70 and US$0.75, and, at exchange rates above this range, the profit margins of exporters are increasingly eroded. Improving commodity prices will buoy the loonie. Uncertainties surrounding the U.S. recovery will lead to the continuing and generalized weakening of the greenback. Such U.S. dollar weakness will be a key upward propellant to the loonie.




With the shock to demand during 2008 and consequent shrinkage of profits, the downturn had already substantially cleaved the number of large and medium enterprises. Such high firm "turnover" will undoubtedly characterize the recovery, as fierce competition for sales continues to eliminate the least productive firms.

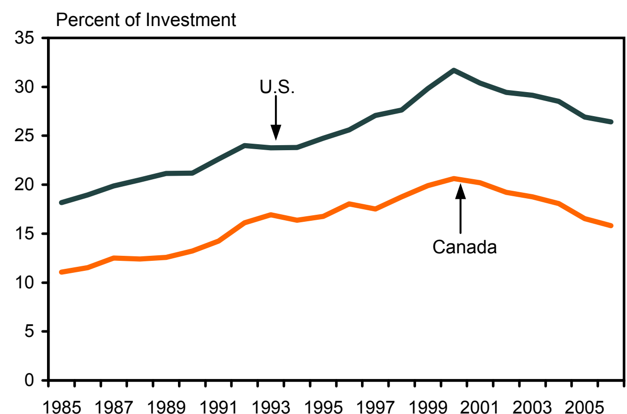
The mix of tepid U.S. demand, a high relative dollar and low relative productivity puts less competitive Canadian firms on notice. Canadian fiscal and monetary policy cannot spur U.S. growth and currency depreciation cannot be engineered without endangering price stability. This means that the only available alternative is for Canadian firms to rise to the challenge and boost productivity. For firms, the market maxim remains: compete or perish.

### Invest to Win

Improving labour productivity means getting more from each hour worked. Economy-wide and at the firm level, productivity growth results from four drivers: the capital stock, the quality of capital, workers' skills, and the way that these factors are used. All of these are somewhat complementary. Firstly, high-tech capital embodies technological advances and requires highly skilled workers. Secondly, getting the most from new capital means developing appropriate business processes and training workers to use the new technology.

As a tangible example, consider a new computerized system for design and production of a consumer product. In order to be used most efficiently, the new equipment must be integrated with how the firm accepts, produces and delivers orders. As well, the firm's workers must have a foundation of creative skills, but also must invest time in learning how the particular software and machinery works. Other examples might be a plastics manufacturer implementing new rapid prototyping equipment, an architectural firm implementing a new database module for computer-aided design, or a retailer implementing a new integrated point-of-sale and inventory-management system. In implementing all these new technologies, there is a learning curve and there will likely be kinks to iron out. Business processes must adapt, and employees must learn how best to use the new equipment. However, such new equipment, coupled with the right skills and set-up, can boost the firm's value-added output for each hour worked.

For Canadian firms to win business and maintain returns, they must be able to produce higher-quality products more productively than their potential competitors. This means



specializing in those goods in which Canada might have inherent advantages. As well, if Canadians want to produce specialized, higher-value goods and services, it also means making investments in new M&E and complementary skills. If Canadian firms cannot compete with foreign firms on productivity, the international marketplace for goods and services will not wait for us to catch up.

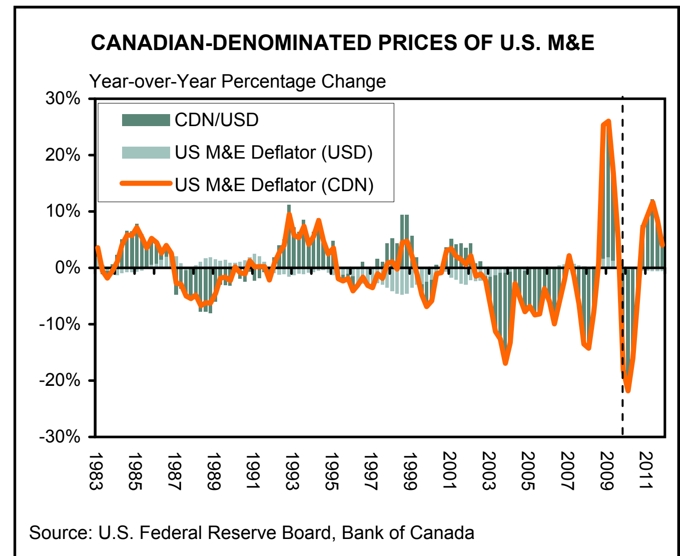
Canadian industry supplies its workers with relatively more capital than in most other OECD economies. However, compared to the U.S., Canada's capital intensity (the ratio of capital to each hour worked) is boosted by our abundance of buildings, but Canadian has lower M&E capital intensity – and lags in information communication technology (ICT) capital in particular. Indeed, as of 2007, Canadian workers only had only 46% of the ICT capital stock per worker as did their U.S. counterparts.[1] Moreover, studies demonstrate that Canadian investments in ICT capital boost productivity in a manner that outstrips the returns on this capital itself.[2] This follows from the intuition that better ICT spurs better business processes and allows skills to be better put to use.

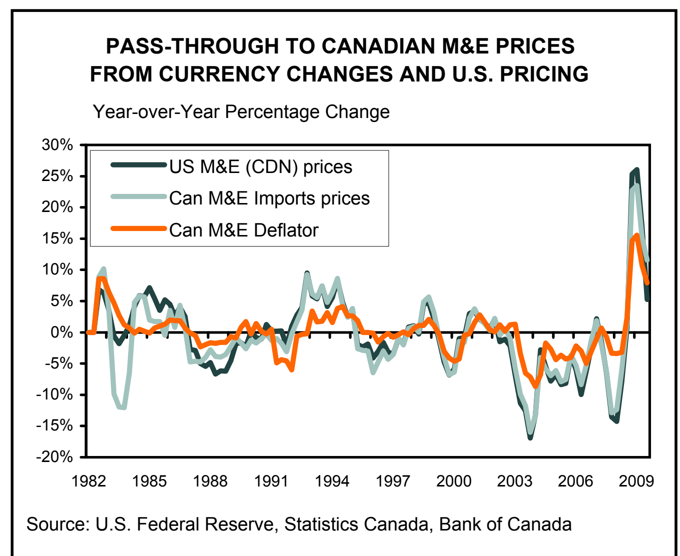
### Now is the time to invest

In the early stages of the economic recovery, corporate profits will grow rapidly in percentage terms, recovering from their plunge during the recession. Those firms who are most productive and leverage their natural advantages will stand to gain market share and maximize their capture of this rebound in economy-wide profits. Indeed, the downturn-to-recovery transition presents a unique window of opportunity where the relative cost of capital goods has sunk, but where loans carry low rates and near-term profits could be great. Firms who invest strategically around this turning point have strong prospects for heightened returns.

The current prime borrowing rate is 2.25% – the lowest nominal bank lending rate on record. We do not expect the Bank of Canada's overnight rate to rise until late 2010, but upward pressure on bond yields during early-2010 will likely begin to increase banks' cost of funds. The Bank of Canada is maintaining the present low interest rates precisely to spur economy-wide investment, and the firms who can best put loaned funds to use now will benefit.

While the high loonie presents a drag on exporters, it also dramatically improves the affordability of capital goods imported from abroad. Indeed, the measured prices of Canada's M&E imports move almost one-for-one in sync with the combined changes in U.S. M&E prices and the CAD/USD exchange rate. The continued drop in U.S. M&E prices coupled with a loonie rising to parity will further reduce the cost of such specialized capital equipment over the next quarters. Since approximately 70% to 80% of Canadian M&E is imported, this improves M&E costs for Canadian businesses.

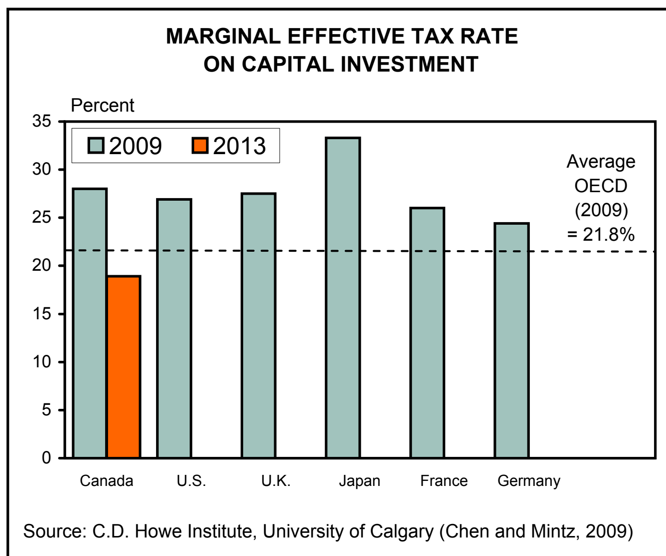


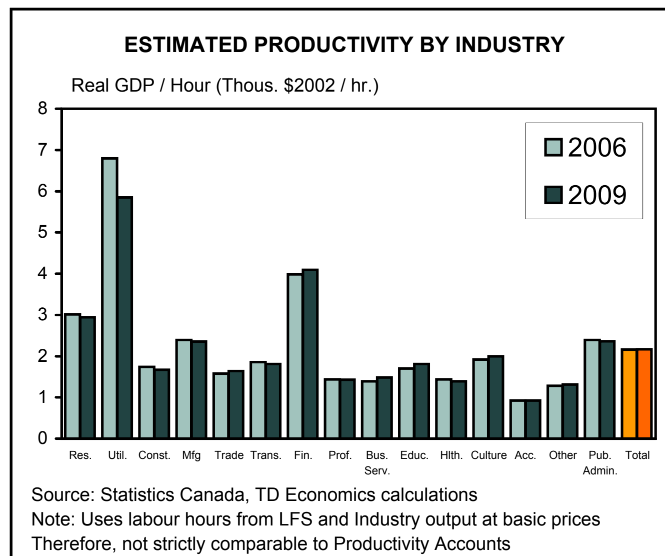




Lastly, federal and provincial governments have taken bold steps to reduce taxes on capital investments. This includes the staged reductions in corporate income taxes, the elimination of import tariffs on M&E, the temporary acceleration of Capital Cost Allowances (CCA), and, most importantly in Ontario and B.C., the sales-tax harmonization with the federal GST. Accelerated CCA enhances the favourable tax treatment of M&E - particularly, computers and software - but the limited horizon (applicable to assets acquired before 2011) means businesses must "use it or lose

1 Centre for Study of Living Standards. "ICT Database: Canada vs United States" Available at: http://www.csls.ca/data/ict.asp

2 Leung, D. and Zheng, Y. "What Affects MFP in the Long-Run? Evidence from Canadian Industries" Bank of Canada, 2008.




it". Harmonization reduces taxes on capital equipment and other inputs to production. These measures dramatically lower the marginal effective tax rate (METR) on capital. The METR represents the tax burden on an investment's minimum return that is required for it to be profitable. Reducing the METR improves returns on any investment and thereby boosts the number of profitable investments. Bringing Canada's METRs well below the present OECD average is likely to enhance the appeal of capital investment.

Obviously, investments must be made prudently and with a keen eye to the future. The downturn accelerated structural changes in economies worldwide, and it has become a cliché that the post-recovery world will not be as it was. Firms should not count on the same sources for sales on which they depended before the downturn. Investing wisely means properly gauging prospective demand. Moreover, the shift in sources of demand will mean a shift in product mix for many firms. Again, this is a key consideration in choosing technologies. As always, uncertainties about the future mean that the best technologies in which to invest are those that are flexible and fit within a variety of business scenarios, both improving firm productivity and heightening adaptability.

### A win-win for business and the economy

Economies only grow when firms' output grows, and the same applies to improving Canada's faltering productivity. Indeed, as labour force growth slows, firms will need to get more out of each worker and the growth of the overall economy will increasingly depend on growth in productivity. Although public policy must be supportive, the presently faltering economy-wide productivity is a business-sector problem and it demands a solution from Canadian business. Broadly, this solution is for Canada's firms to invest and innovate.

Market competition means that the most productive firms survive and thrive, and firms can expect that competition to intensify – in both foreign and domestic markets. Making investments in high-tech capital is critical to Canadian firms' success and thereby to boosting the productivity of the entire Canadian economy.

With courageous cuts to taxes on capital, governments have set the right conditions for investment. Having weathered the storm resiliently, Canada's financial system remains robust, banks remain willing to lend to good projects, and interest rates are at unprecedented lows. In the past, some firms relied on a weaker loonie to bolster competitiveness. This is no longer possible. Rather, firms must look to compete internationally on the basis of productivity. Indeed, firms must seize the opportunity from exchange rate appreciate to invest in correspondingly cheaper imported M&E. Canadian firms must rise to the challenge and invest to better compete.

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