Canada enjoys a manufacturing boom, for now

By David Parkinson
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Over the past couple of decades, we've grown unaccustomed to hearing the words "Canada" and "manufacturing boom" in the same sentence. But over the past few months, Canada has put together a nice little manufacturing boom.

Whether the two can remain in the same sentence for a more sustained stretch could depend in no small part on Ottawa – and the government's success on the NAFTA and tax-competitiveness fronts. Without removing those key uncertainties that are holding back business investment, manufacturers' runway for booming looks pretty short.

Statistics Canada reported that March manufacturing sales rose 1.4 per cent month over month on a seasonally adjusted basis, building on the 2.7-per-cent surge in February. Despite a slow start to the year, growth for the first quarter as a whole was at an annualized pace of nearly 9 per cent.

In fact, manufacturing has been expanding impressively since the middle of last year, save for a couple of temporary hiccups. At a time when rising interest rates are weighing on Canada's housing sector and consumer spending, the manufacturing sector has emerged as a key driver of economic growth for 2018. And with unfilled orders up 4.5 per cent in the quarter (18 per cent annualized), there's plenty of reason to think this growth spurt has some legs.

"Sales have been strong for two consecutive quarters, and momentum suggests more to come," Bank of Nova Scotia economist Derek Holt said in a research note.

But the problem is that increasingly, there are physical limits to that momentum coming into play. Many segments of Canada's manufacturing industry are running at or near full capacity.

In the fourth quarter of 2017 (the most recent data available), capacity utilization in the manufacturing sector was 86.1 per cent, a 17-year high; some industries – such as forest products, plastics, and petroleum – were operating well above 90 per cent capacity. The hot first quarter of 2018 has almost certainly tightened spare capacity further.

In the Bank of Canada's spring Business Outlook Survey released last month, nearly half of businesses said they would have "some" or "significant" difficulty meeting an unexpected increase in orders. Most said they expect capacity pressures to increase over the next 12 months, "pushed by strong sales prospects and expected difficulties finding labour," the central bank reported.

So far, manufacturers have managed to keep up with rising demand by hiring: the sector added nearly 90,000 jobs (more than 5 per cent) in 2017. But the effects of that hiring spree are now playing in the form of rising wage pressures amid competition for an increasingly shallow pool of available skilled workers. In the first four months of 2018, average hourly wages in manufacturing went up at an annualized pace of nearly 6 per cent.

What's becoming clear is that manufacturers are running out of room to address their rising demand with more bodies; the cost and availability of labour are forcing their hand. They need to invest in expanding their operations.

"For this [growth] to continue, we're going to need more evidence of capital spending on plant expansions," Avery Shenfeld, chief economist at Canadian Imperial Bank of Commerce, said in a note to clients.

But despite the obvious capacity pressures, the same Bank of Canada survey shows that companies have grown increasingly hesitant to invest in new machinery and equipment over the next 12 months. The survey indicates that the persistent uncertainties surrounding the NAFTA trade negotiations, as well as the impact of U.S. corporate tax cuts on Canada's investment competitiveness, have made many business owners gun-shy about capital spending.

As the capacity pressures grow more acute, the impact of these uncertainties on domestic business investment decisions become an increasingly pressing issue hanging over the country's economic outlook. It's fair to say there is some urgency growing for the Canadian government to produce some clarity on both fronts.

Ottawa is working on it. Just today, Canadian officials suggested that nailing down a NAFTA deal in the coming weeks is certainly still possible – although the ball seems to be in the court of U.S. policy makers and legislators, who apparently can't agree on their own timeline for reaching an agreement. The Canadian government is also looking into measures that might aid the country's competitiveness, in response to pressures from the business community to address the U.S. tax cuts, although we're at least a few months away from seeing that plan come to fruition.

But progress on both fronts – or, at least, a clearer view for business – may be critical to supporting the investments that the manufacturing sector will need to keep its current expansion going. Without the confidence needed in these key policy areas that will convince plant owners that it's safe to spend, the sector is going to increasingly bump its head on its own growth ceiling.