Fidelity Connects

Canada's Economic Path Forward

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Hello and welcome to Fidelity Connects, a Fidelity Investments Canada podcast, connecting you to the world of investing and helping you stay ahead.

The Bank of Canada has raised its key benchmark interest rate seven consecutive times in 2022 in its fight to tame inflation. Canada's key lending rate now sits at 4.25% - its highest in nearly 15 years. So, as we look to the next market cycle, how can Canada boost growth and productivity? And how can investors protect themselves from what's to come?

Joining us today to discuss Canada's path forward is Economist Jack Mintz and Analyst Philip Cross, speaking with host Pamela Ritchie.

Jack Mintz is the President's Fellow of the School of Public Policy at the University of Calgary and Distinguished Fellow at the MacDonald-Laurier Institute. Philip Cross is the former Chief Economic Analyst at Statistics Canada, and is currently a Senior Fellow at the MacDonald-Laurier Institute.

A few key insights shared today include noting that we're finally going through some deleveraging, meaning that housing prices will most certainly be tempered in the big markets like Toronto and Vancouver, where prices went up extraordinarily high. Our guests also look at provincial budgets, noting that budgets have been balanced to a large extent, except for Ontario. Oil is also discussed today, with our guests sharing how the oil price is back to levels seen prior to Russia's invasion of Ukraine.

This podcast was recorded on December 13, 2022.

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Pamela Ritchie: Jack, if you don't mind, I'll begin with you. I wouldn't mind you just kind of laying the foundation for us of where you think the demographic picture is for Canada at this point. We put that to a side throughout much of the pandemic, but it feels like it's pretty much right back at the forefront.

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Jack Mintz: Well, what I've written, actually, once in the Financial Post just a little while ago, Canada's population is very quickly ageing. In fact, in 2020 there was about one person over the age of 65 for every person that was between the employable ages of 15 to 64. By 2035, that's going to increase to two people for every five people. In other words, two seniors to five people that are working. Canada is not the only one that's rapidly ageing. So is every high-income country in the world. In fact, it's almost the same across all of them and many middle-income countries. In fact, when you look at the world as a whole it will be ageing, although not as dramatically as what's happening in the high-income and upper-middle-income countries.

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What all that means is that we're going to be seeing labour being tougher to hire and skilled labour internationally is going to be very competitive in terms of the way that markets are going to operate. That will also mean that wages will rise and those countries that have good productivity gains will be able to basically offer higher incomes for many people as long as we get the productivity gains to accompany those rising wages, otherwise they're going to have a tough time with competitiveness.

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Pamela Ritchie: Very interesting. That goes to sort of opening up the discussion of the structural inflation discussion. We'll come back to that several times, I think, in this conversation.

Philip, if you don't mind, I'd like to ask you to sort of point us to the inflation story, essentially, that spikes along with the energy story. They really were one and the same. In the month of February of this year, this is when Russia invaded Ukraine and we saw that spike that was with us for much of the year. Just sort of take us back to what that looked like, the impact that that had to the inflation story, maybe more short term, we can get into that.

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Philip Cross: It certainly had a major impact, particularly in Europe, which is still dealing with extremely high level of natural gas prices and the same oil prices we're dealing with. But it really is more a question of, it really seemed to have gotten the attention of a lot of the public and even central banks. It's when the Bank of Canada finally started raising interest rates, was in March of this year just after that invasion. But clearly, inflation had been on an upward trend before that. I mean, we were looking at rates of 4, 5%. I wrote a commentary in October 2021 warning that this was not going to be the supply side transitory supply shock that central banks were assuming, that all of that stimulus we injected into the economy during the pandemic from both fiscal and monetary policy was boosting the underlying rate of inflation.

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I think we're seeing that today. The oil price, when you go fill up at the pump today it's basically back to pre-invasion levels and yet we saw today in the U.S. inflation is running at 7.1% despite lower gas prices. No matter what its origin, inflation is becoming increasingly embedded in our economy. We see that in wage rates in both Canada and the U.S. They're very consistently at 5% these days. I think wringing inflation out of the system is going to be a lot more difficult than a lot of people are thinking.

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Pamela Ritchie: Jack, what does it do? Tell us your view on sort of the interest rates trajectory. There are lots of different pieces, obviously, that Tiff Macklem has to hold, our housing market being a huge part of that. How long do we sit with high inflation, do you think?

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Jack Mintz: Well, I think it's going to be a bit longer than we think or at least the market might be anticipating. The reason for that is the extraordinary excess demand that has been for labour in the market. I mean, when you look at Canada, for example, and the last time I looked at the numbers which was just a month ago, we had a million job vacancies and at the same time 1.1 million unemployed people. Now, there's always bound to be some unemployment due to mismatching and structural issues but what it means is that it's going to take time in order for interest rates to work through the economy. It will bring down demand but we're not going to see a rise in unemployment for a while because people are still going to get hired and, as a result, the economies will still be stronger than we anticipate and inflation will still be supported through higher wage claims, just as Phil mentioned. I think we're looking at 2023 with inflation probably in the 4 to 5% range, and assuming no other supply shocks which who knows what comes down the road in 2023. But I do think that we're not going to get to 2% until probably 2025.

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Pamela Ritchie: Philip, anything to add there just sort of on the outlook where interest rates, but really inflation, sit?

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Philip Cross: I'd agree with Jack that we're probably past peak but it's going to be very hard to get the underlying core rates of inflation down. I mean, we're seeing drops in goods prices. We're definitely past peak in energy, food prices should drop, we've had very good crops in North America but the services is going to be, that's going to be a much more difficult component. The idea that we're going to solve … we're dealing with the highest rate of inflation in four decades … the idea that we're going to deal with this with just a 4-percentage point hike in interest rates and we can continue to run fiscal deficits and we'll just have a 10 or 15% drop in the stock market and then everything will go back to normal, I think is extremely unrealistic and overly optimistic.

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Pamela Ritchie: Let's go to the fiscal story. Jack Mintz, can I ask you to step into this discussion? If you have the central banks all around the world, all of them are making decisions this week. This is a huge week also for data, but essentially central banks trying to rein it in. Where is the place for fiscal? You can look at countries around the world. There's an argument for this should be the end of fiscal spending. I mean, whether that's the case or not, I don't know.

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Jack Mintz: I do think that governments are going to have to bring in what's called fiscal consolidation by the IMF and other agencies which is really some form of austerity, ultimately. What we've seen in the past year has been very robust revenues coming in, and that's been due to very high nominal GDP growth which is especially reflective of the very high inflation rate that we've had.

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Pamela Ritchie: Sorry, all levels of government in terms of revenue? Do you want to just spell that out?

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Jack Mintz: Yes, all levels. In fact, the provinces have now basically balanced their budgets to a large extent, except in Ontario. We've also seen the federal government deficit come down quite a bit as well. But that situation is going to change very quickly in the next two years because what we're going to do is see a slowdown in the economy. We're also going to see higher interest rates which means higher debt charges. And just as a point that no one has really made: I calculated what the increase in transfer payments are going to be under our indexed system for the federal government and the provinces follow...

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Pamela Ritchie: Are you about to make news here? Do we know about this?

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Jack Mintz: Well, I did mention in one article but I did a calculation using the methodology that has been used in the past in order to calculate what would be the increased indexation for January 1st for payments, and some of them come in later in July 1st, but it's going to be over 9%, a little bit over 9%, which is huge. So, that's going to be a very significant boost in federal spending because there are many transfer payments that are indexed for inflation. It also means that, of course, all the income tax brackets are going to be increased by 9% as well.

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Pamela Ritchie: That's very interesting. Philip, you were at Stats Can, take us through some of the points you find interesting out of this discussion.

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Philip Cross: Well, I agree with Jack that in the short term inflation has been a benefit to government. We've gotten deficits down to less than 2% of GDP. They're likely to go up for the reasons Jack just enunciated. But it's also important, you know, we're very tied in with the U.S. economy and there we're seeing deficits, even before the slowdown in the economy and these other events, we're seeing deficits of 5% of GDP. These are the levels at which Liz Truss in the U.K. was running her deficits when markets baulked.

So, I think people underestimate how much stimulus is going into the U.S. economy that's going to have some impact here. In economies that are running at above capacity, running deficits of this type are just going to make it that much more difficult to bring down inflation.

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Pamela Ritchie: Jack, how is the housing, is the housing market reacting in all the, I won't say correct ways, but the textbook of how, ultimately, you take the steam out. There's a lot of discussions around the housing market right now and even sort of the potential for contagion. I might get your thoughts on that. The Canadian housing market has held up this incredible growth of the last 20 years. What does it mean to see the pin sort of pricking that, in your mind?

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Jack Mintz: Well, I think in some ways it's healthy. Finally, the housing market is going to be blowing off some steam in the sense that we've had a huge run up in prices. Even during the 2008/09 recession, Canada did not suffer that much in terms of the housing market. We were able to maintain really strong housing market even at that time. With low interest rates, of course, people have bid up the price of housing to extraordinary values recently. I think this slowdown, which has made actually Canada's housing market one of the fastest rising markets in the past decade and a half in the world – I think only New Zealand and Australia match us – we're finally going to be going through some deleveraging. And that's going to mean that housing prices will certainly be tempered, especially in the big markets like Toronto and Vancouver where prices went up extraordinarily high, they'll especially feel the heat as these changes occur.

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Now, we also know that the only real investment that's gone up in Canada over the past... since 2015, has been in residential investment. We haven't done very well in non-residential investment. That means our investment picture is going to be probably weakened to some degree unless we make up for it in terms of more business investment in Canada which has been rather weak for the past seven years. So, I think we're going to see that this will also have an impact on, at least a macro economic impact, on slowing down the economy as well.

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Pamela Ritchie: Let's go to growth and discuss that. Philip, is there enough innovation in this country, do you think, to bolster that? We're also going to bring the commodity discussion in a second here but do you see innovation across Canada, the growth story, productivity growth? Where does that stand for you?

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Philip Cross: I think everybody who looks at the data will say innovation and productivity in this country has just been abysmal, and it's been abysmal for decades now. It's quite striking. We live next door to the most innovative, one of the most high-productivity countries in the world, the United States and yet, you know, we don't seem to be able to match them when it comes to this innovation.

Economists have recommended a lot of specific things like free trade. It was just announced last week from Stat Can: we have the most educated labour force in the world. We do a lot of these things right and yet it doesn't show up in the productivity numbers. This is what Don Drummond, one of your recent guests, saw the conundrum of Canadian economics. We adopt a lot of these policies that economists recommend and yet we don't see a big payoff from them. I suspect it's because of we don't have a good relationship between government and business. We don't encourage the kind of innovative business culture that the Americans do. I think we've got to work on that more and less specifically on policies like high immigration and so on.

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Pamela Ritchie: Let's get into that in a second. Maybe that's for you to take a look at, Jack, but what do you think on the innovation, the growth prospects for this country, productivity, boosting it somehow. What's the path for that?

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Jack Mintz: Just to kind of reiterate something that Philip said but I think I'm going to say a little bit more strongly: we've had abysmal productivity, usually 1% per year in terms of labour productivity growth, for quite a while now, for several decades. But actually, since 2015, it's actually been close to 0%. In fact, if you take out the 2020 year it would be about half a point. We're actually even more abysmal than we have been in the past. Now, when I look at the future, I'm actually quite concerned that there's a lot of headwinds for productivity. We're going into a world where we're looking at trade restrictions, emphasis on domestic supply, or friendshoring. All that means is more tariffs, more barriers to trade, which we know can have an impact on productivity.

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We have the demographic ageing problem which is very rapid right now. That's also going to have an impact on productivity as our senior people retire and we don't have enough young people coming up. Even if we bring in more immigrants, they're not necessarily the kind of skills that you have at the beginning. That takes a long time for them to really move to a level that would be similar to other Canadians. They don't come in with the same skills as other Canadians currently have. And then we also have indebtedness of government. We've already talked about, plus our low investment rate. Combining all that together it looks pretty bleak actually this decade.

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On top of it, we have a very expensive energy transition where we're going to be substituting the most highest-value added per working hour industry, oil and gas, with other industries that are going to be less productive and we have no concept of how expensive energy prices are going to rise during this time. So, all that is pretty bleak.

The only good thing that I think is the private sector has an amazing capacity for innovation. We've seen it with the pandemic, with vaccines, the ability to work at home, and I think what Canada needs to do is to particularly focus on deregulation and getting its act together in terms of that. In fact, that's one area that we have not done a very good job over the past 20 years or 30 years, has been to deregulate this economy and encourage more innovation. It's gone the other way, actually.

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Pamela Ritchie: What does that look like, Jack? What does that mean? What is the policy prescription, even just broad strokes, for deregulation to stimulate productivity and growth?

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Jack Mintz: Well, look how long it takes to build something in this country. I mean, not just in the resource sector but whether it's a condominium in a downtown area or even a commercial warehouse. In fact, the World Bank did a survey amongst all the countries just building a commercial warehouse and Canada actually had one of the worst records amongst OSC countries in terms of the time taken to get a commercial warehouse built. That's really amazing.

We really have a long way to go in terms of regulation and a big part of it is governance where people will object to various things or municipalities want to have certain control over zoning and a whole bunch of other factors. I think it's an area that really needs a lot of work because we could throw all the tax incentives we want at businesses but if we don't get the regulatory environment right, we won't be able to move ahead in terms of investment.

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Pamela Ritchie: What is the role of the resources that Canada has in the ground going forward? We will discuss the energy transition. That's all probably part of the same story. For sure it's part of the same story, but what is the role for commodities in Canada's growth picture?

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Jack Mintz: Well, as I've written about just recently, certainly we have some mining resources but I think there's also a lot more hype than there is realism about what we can accomplish in terms of mining. As we pointed out in a paper just last week using U.S. data, that actually Canada really doesn't have huge reserves in a lot of the, what you might call, critical minerals, that are available. It doesn't mean that we may not find some more but we're talking about maybe 2, 3% of world reserves in areas like nickel and zinc and cobalt, which is really quite small. I mean, the countries that really have these critical minerals are in Africa, Latin America, Australia, China, etc., and that's where the minerals are going to be. A good example is we have some great mining companies that can find a lot of those minerals abroad because there won't be as many as we think here in Canada.

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Pamela Ritchie: Philip, what would you add to that, the role of commodities broadly in Canada's growth picture going forward.

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Philip Cross: I think it's symbolic of why we've fallen behind the U.S. I mean, the U.S. is exporting huge amounts of LNG and oil. They've become the world's largest exporter of fossil fuels, particularly to Europe as they replace Russian supplies, and yet we can't to agree to build any capacity here. At best we ship our LNG to the U.S. at a low price and then they export their LNG to Europe at a high price. To me, it's just symbolic of how Canadians just haven't created the proper environment, including regulations to develop our economy to its potential.

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Pamela Ritchie: Jack, this one is coming in, what are your thoughts on the prospects of stagflation in the Canadian economy? Are we seeing it now? What do you think? Kind of start us off with this.

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Jack Mintz: I've actually written in the past that actually, in a way, we were already in stagflation. We had rising inflation while at the same time even though the employment numbers were relatively good. We were really actually in kind of a weakening situation in terms of our demand. I think what we are going to see is a period over the next two years of still inflation but rising unemployment as we finally soak up this excess demand for labour that's sitting out there. I think this is really the key difference between what we're facing now and what we've ever faced before, at least for some time, especially since the 1970s.

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Pamela Ritchie: Philip, what do you think? You've mentioned the U.S. doing things better from your perspective. For investors, what do they need to think about if that's the case? What do you think investors need to think about going forward?

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Philip Cross: Well, I think, obviously, the U.S. is a more promising area for investment in the current political climate in Canada but more broadly, too, we're looking at persistent inflation for longer than markets were expecting. That's what we've been talking about in this program and that implies you want to invest in areas that profit from inflation, areas like commodities, also areas, industries that benefit from the increasing spreads in interest rates. Banks, life insurance companies, for example, some of them have done quite well over the last year even as the macroeconomic climate has deteriorated.

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Pamela Ritchie: Jack, to you as well. So, looking forward what does an investor want to keep either top of mind or certainly in the back of their mind as they move forward?

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Jack Mintz: Well, I think, first of all, on energy markets which I'm quite familiar with, I think one of the things that we are still going to see is a drag on investment globally for both oil and gas and yet there's still going to be remaining demand, very strong demand, for oil and gas worldwide. I expect actually that prices will be relatively high for much of this decade as a result…

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Pamela Ritchie: High like above 70 or high like above 100?

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Jack Mintz: Oh, yes, above 70, even above 80. I'm not going to be predicting $150 barrels but I do see that we're looking at the 80 to $100 range, I think, for oil continuing. Of course, natural gas is going to also rise. Those are going to be fairly good, I think, for investment. But at the same time, mining is also going to be fairly good. We are going to be going into a mining boom and I think that will also be good for Canada. Anything that's good for the resource sector will be good. Of course, agriculture could be fairly strong as well. On that side I think Canada looks pretty good. I think the real concern I have is manufacturing, where manufacturing has been slowly declining in Canada over the years.

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Right now I'm just not sure exactly what future we have except for governments throwing money into subsidizing electric vehicles and things like that. To me, that's not growing the manufacturing sector. That's coming with a huge economic cost because eventually somebody has to pay for all those subsidies. The question is, can we have a manufacturing sector that's going to be competitive internationally and highly innovative? I think we have elements of that, but I think we have a long way to go with respect to a stronger manufacturing sector.

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Pamela Ritchie: What if you threw a carbon price in there and let the markets figure it out a little bit?

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Jack Mintz: Well, I'm a great fan of carbon pricing in the sense of it's neutral and let people figure it out. Last night, there was an announcement about nuclear fusion where you can create more energy, where they actually had some success in the United States, creating more energy than putting in energy in order to achieve nuclear fusion. If that takes off, that could have a dramatic impact on energy markets way in the future. Of course, we're far from that and usually these things take several decades before they become commercial but the main point is that we're in a great deal of uncertainty when it comes to how these eventual innovations are going to be derived.

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Everyone says, okay, we're going to do hydrogen or we're going to do nuclear or we're going to do this but it all depends on what's going to be competitive down the road, what's going to be the cheapest source of reliable energy, and that we'd have no clue yet. As a result, I like carbon pricing from the point of view of being neutral in that we're not trying to pick the technologies, but we're not doing just carbon pricing in Canada, we're doing everything else. We are picking winners and losers and I think that's going to come with a very high cost. By the way, the U.S. is also doing that which I think we may find that we're going to be throwing a lot of money into certain things that are just going to go bust.

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Pamela Ritchie: Philip, final sort of 30 seconds to you just with a final thought, if you have one, based on what Jack said or otherwise.

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Philip Cross: I'd agree that one of the problems with this country is that we confuse subsidies with being pro-business. We subsidize mining, we subsidize electric vehicles, and we somehow think this proves the credentials of government being pro-business. No. Governments should just be setting the rules and then getting out of the way, basically, lowering taxes and letting business sort it out instead of picking winners, as Jack said.

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Pamela Ritchie: Jack Mintz and Philip Cross, I want to thank you both very much for joining us and leading this conversation for us to think about what is next, what's on the horizon and what needs to be done. Thank you for your time.

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Thanks again, see you next time.