Economic Viewpoint

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Investment by Quebec businesses:
An overview of determinants and outlooks

Business investment is not a straightforward component of GDP. With consumers and governments keeping a tight grip on their purse strings, an upswing in investment would be quite welcome. However, it is taking its time in arriving, even though interest rates have been at historic lows for a decade. What's more, businesses' financial situations have improved substantially in recent years, and there is no shortage of cash on hand. The weak economic outlook and global uncertainty are removing the incentive for investment efforts, and making businesses cautious. At the same time, new business models are being deployed, based on the continuous integration of research and development (R&D), organizational and commercial innovation, and new production and communication technologies. In this time of great economic change, it seems that, beyond volume, the vitality of investment can also be measured in terms of businesses' capacity to increase their expertise and expand their networks.

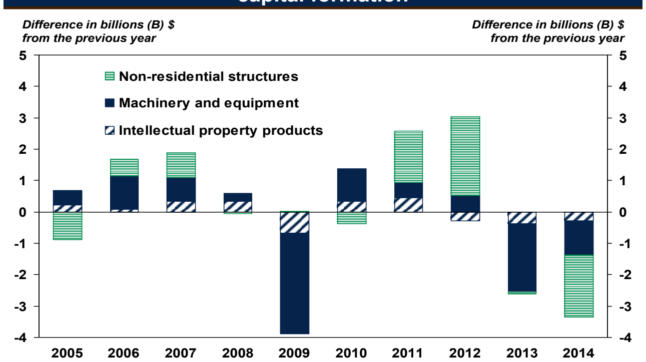
QUEBEC BUSINESS INVESTMENT: TAKING STOCK

Following the 2008 crisis and 2009 trough, non-residential business gross fixed capital formation rose in 2012, then declined in 2013 and 2014 (graph 1). In the last two years, the slide occurred in all components, taking it below where it was in 2008.

Annual growth by the non-residential business gross fixed capital formation was -7.1% in 2013 and -11.2% in 2014. In the first and second quarters of 2015, annual growth by the non-residential business gross fixed capital formation was -4.2% and -2.8%, with non-residential structures contributing the most to the decline. Moreover, the capital expenditure survey projects that the trend for private business investment will be negative for a third straight year in 2015 (see box on page 2).

Business investment therefore seems to be lacklustre. Moreover, the weight of non-residential business gross fixed capital formation in Quebec's final total domestic demand[1] has been fluctuating between 8.0% and 10.0% from the start of the 2000s to 2014. In 2011, 2012 and 2013, non-residential structures[2] buoyed the effort to keep total investment at around or just above 9%. Simultaneously, spending on machinery and equipment, as well as intellectual property products, has been sliding since the recession (graph 3 on page 2).

Graph 1 Quebec: Non residential business gross fixed capital formation



Sources: Statistics Canada, Institut de la statistique du Québec and Desjardins, Economic Studies

[1] Final domestic demand: Total GDP excluding investment in inventory and net exports.

[2] Non-residential structures include the gross value of new non-residential building except for defence installations and additions, renovations and alterations that extend an existing asset's lifespan. They fall into two categories: 1) construction of permanent structures (industrial, commercial and institutional) and the installation of such things as electrical cable or elevators; 2) engineering works (e.g. the construction of power transmission lines, mining operations, dams, railways and pipelines).

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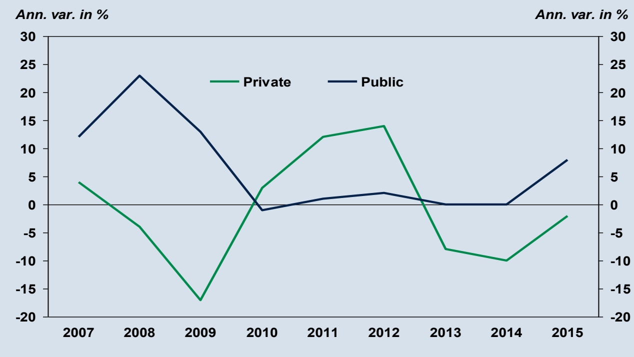
BOX
THE OUTLOOK FOR PRIVATE BUSINESS INVESTMENT IS NEGATIVE IN 2015

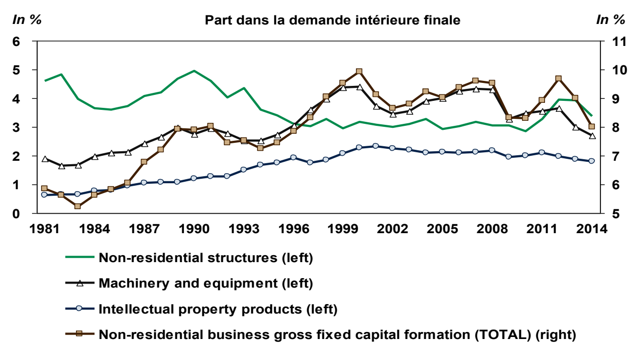
For Quebec, the capital expenditure survey projects annual growth of 3% for 2015, following declines of 5% in 2013 and in 2014. While the promised upswing is encouraging, it will mainly result from investment by public administrations (+8%), while growth by private sector investment should remain negative in 2015 (-2%, following slides of -8% in 2013 and -10% in 2014) (graph 2). The survey also shows that the 1 billion dollar gain in capital expenditures forecast for 2015 will mainly come from construction (with a share of 63%). The increase in spending on machinery and tools (+365 million dollars in 2015, or 37%) will not be enough to make up for the contraction accumulated in previous years (-4.5 billion dollars from 2007 to 2014).

Graph 2 Quebec: Capital expenditures
Total (public and private), % annual growth



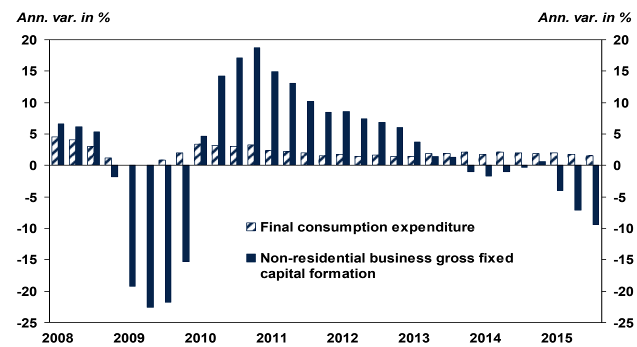
Sources: Statistics Canada, Institut de la statistique du Québec and Desjardins, Economic Studies

Graph 3 Quebec: Non residential business gross fixed capital formation % of final domestic demand



Sources: Statistics Canada, Institut de la statistique du Québec and Desjardins, Economic Studies

Graph 4 Canada: GDP in terms of expenditures, consumption expenditures and business gross fixed capital formation



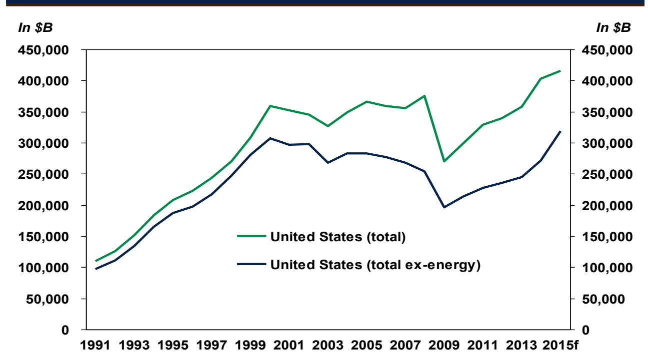
Sources: Statistics Canada and Desjardins, Economic Studies

OVERVIEW OF INVESTMENT'S MAIN DETERMINANTS: WEAK DEMAND AND CONFIDENCE

Demand is one of the leading factors in investment. For Canada, the outlooks final consumption expediture and exports are fairly weak. The data on annual growth also shows that this degree of anaemia has not been seen for about two decades. In Canada, final consumption expenditure growth (quarterly annual change from one quarter compared with the corresponding quarter of the previous year) has not exceeded 2.4% since the first quarter of 2011, and has stayed below that level since then. Since 2013, weak consumption growth has been followed by near stagnation by investment (graph 4).

On the other hand, in terms of U.S. demand, the prospects for Canada are improving. The data in fact shows an increase in U.S. demand in most export industries, as the weak loonie has improved Canada's competitiveness. Since 2010, total exports have been on the rise following

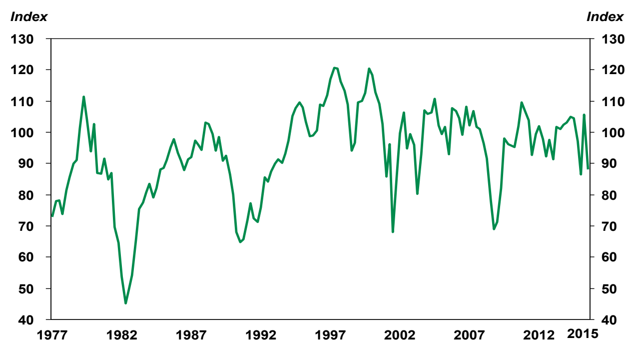
Graph 5 Canadian exports to the United States



Sources: Statistics Canada and Desjardins, Economic Studies the recession (graph 5). If we look at Canadian exports to the United States excluding the energy component (fossil fuels and electricity)[3], we see that there was a decline in the early 2000s; the recovery that started in 2010 has still not managed a return to the peak reached in 2000. The upswing is quite recent. The question is whether the trend will hold and, if so, for how long.

In the last decade, Canadian business confidence has hardly edged above where it was in 2002 and has also been very unstable in comparison with the curves recorded in the 1980s and 1990s (graph 6). Although, in the past, business confidence could experience long upswings, it seems the uncertainty that has characterized the global economy over the last 15 years has left businesses permanently cautious, with a direct impact on their propensity to invest.

Graph 6 Canada: Business confidence index

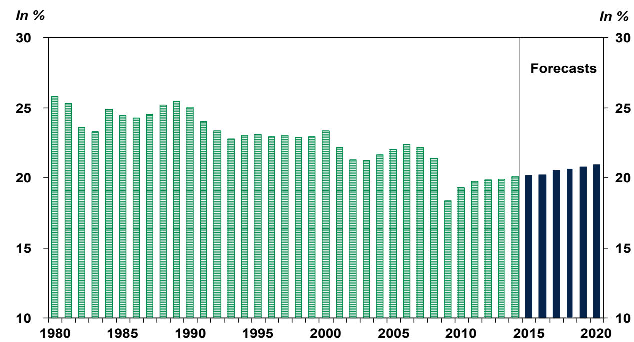


Sources: Conference Board of Canada and Desjardins, Economic Studies

Also, this scepticism can be based on broader perspectives: the IMF's economic projections through to 2020 do not conclude that the global economy will decline, but point to a clear lack of vitality. In 2015, global growth will be just 3%, and then only rise very slowly to 4% in 2020. Moreover, trade in goods and services will tend to stagnate. Also according to the IMF, economic growth by G7 nations will not beat the 2% mark before 2020. As well, investment by G7 nations should advance into 2020, but too slowly to reach the pre-2007 level (graph 7), prior to the financial crisis.

The production capacity utilization rate, one of the factors in investment, will not help improve the outlook either: from 1987 to 2015, the average production capacity utilization rate was 82.5%, cresting to 87.6% in Q1 of 1998.

Graph 7 Investment, G7 advanced economies % global GDP



Sources: IMF, World Economic Outlook Database, October 2015 and Desjardins, Ecnomic Studies

The industrial capacity utilization rate tumbled to 71.6% in 2009, and has returned to, but not really exceeded its historic average (82.0% in Q3 of 2015).[4]

In this kind of context, it is difficult for business to contemplate taking a risk on new investment projects. Moreover, accelerating globalization has exacerbated international competition, throwing a monkey wrench into the usual markets of various economies, all of which are engaged in tweaking their competitive positions. This long, delicate transition may be responsible for the relative softness of investment by Canadian and Quebec business.

Businesses' hesitancy could also explain the emphasis they have been placing on improving their financial situations in recent years. In 2010, the net earnings of Canadian non-financial businesses hit record levels[5]. In the last five years, the profit margins of non-financial businesses have oscillated between 7% and 8%, which is fairly high in comparison with the historic data. This occurred in tandem with a major drop in their debt ratios, particularly since the 2008 crisis (graph 8 on page 4). At a press conference following a speech delivered in August, 2012 and covered by the media, then Bank of Canada Governor Mark Carney remarked on the substantial liquidity held by Canadian businesses and what he would like to see them do with it.[6]

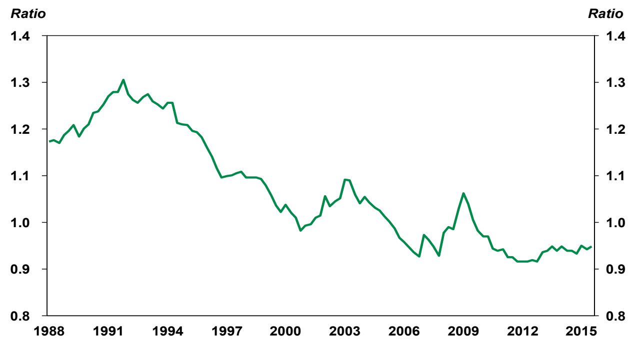
[3] Using Statistics Canada's nomenclature: HS-2709 - Petroleum oils and oils obtained from bituminous materials, crude; HS-2710 - Petroleum oils and oils obtained from bituminous materials other than crude; HS-2711 - Petroleum gases and other gaseous hydrocarbons; HS-2716 - Electrical energy.

[4] "A prolonged period of deteriorating competitiveness, punctuated by the Great Recession, led to the destruction of many firms and depressed business investment outside the energy sector, resulting in significantly reduced capacity in the non-resource sector." Bank of Canada, *Monetary Policy Report*, October 2015, p. 23.

[5] Businesses' profit margins averaged 4.8 in the 1990s, 6.2 in the 2000s, and 7.2 since the start of 2010 (source: Statistics Canada, Cansim 187-0002).

[6] Financial Post, August 22, 2012, "*Stop sitting on your cash piles, Carney tells Corporate Canada.*" http://business.financialpost.com/executive/dont-blame-the-loonie-for-weak-exports-carney-tells-caw

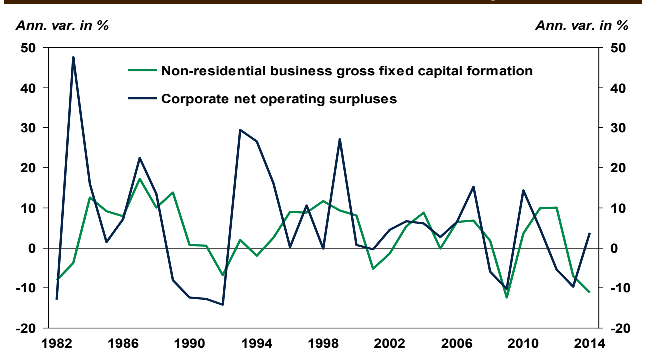
Graph 8 Canada: Debt ratio
Total of non financial activity



Sources: Statistics Canada and Desjardins, Economic Studies

That being said, the latest GDP data indicates that annual growth by private sector net operating surpluses has been coming down since 2013. The trends are similar for Quebec (they lag behind, but look the same graphically, see graph 9); the correlation between profit and investment suggests that 2015 will not see a real rebound by the non-residential business gross fixed capital formation. The data indicates growth by the non-residential business gross fixed capital formation in 2010, 2011 and 2012, with declines in 2013 and 2014, consistent with growth by net operating surpluses.

Graph 9 Quebec: Business non residential gross fixed capital formation and corporate net operating surpluses



Sources: Statistics Canada, Institut de la statistique du Québec and Desjardins, Economic Studies

The overall improvement to businesses' financial numbers does not guarantee that investment will improve. Weak demand could reduce profitability. More fundamentally, in the early 2000s, Canadian businesses faced a breakdown in competitiveness against the United States, primarily as a result of the loonie's rise. This was followed by a technological acceleration and increase in global competition, which quickly spotlighted the importance of focusing on R&D and innovation.

How can we assess the vitality of investment when performance is increasingly being measured in terms of expertise? How can we measure profitability when we increasingly have to look at it over the long range? What criteria can businesses use to guide their investment strategy when they are having growing difficulty standing out in the context of intense competition and constantly changing markets? In terms of one economy, investment vitality is no longer solely measured in terms of volume. It is also primarily measured in terms of the technological and strategic expansion of productive capacity. Beyond equipment, today, economic potential is primarily determined by investment in intangible capital. The challenge of defining all the indicators remains, but growth by R&D data is still "indispensable" to competitiveness.

R&D SPENDING HAS LOST MOMENTUM IN RECENT YEARS

The latest data on R&D spending gives pause for thought. The data shows that:

- Business intramural expenditure on research and development[7] as a percentage of GDP has tended to decline in Quebec, going from a rate of 1.7% in 2006 to 1.3% in 2013.
- From 2006 to 2013, the value of business intramural expenditure on research and development stagnated at around an average of 4.8 billion dollars, while the R&D workforce clearly declined, falling from 58,000 to 42,000 full-time equivalent jobs from 2008 to 2013.
- Business gross fixed capital formation in intellectual property products fell from 7.2 billion dollars in 2011 to 6.4 billion dollars in 2014. Moreover, the weight of intellectual property products in total non-residential business gross fixed capital formation has been stagnant since 2002 (at 2%).
- In 2011, a total of 138 inventions were patented per billion dollars of intramural R&D expenditure in Quebec, compared with 238 in Ontario.

While these numbers[8] only provide a partial picture of the investment in intangible capital, they show that the momentum needed to strengthen competitiveness is missing. The decline that has characterized manufacturing in recent years is largely responsible for the drop in R&D expenditures, and this sector's weight is usually above 50% in Quebec.

[7] "Intramural expenditures: Expenditures for R&D work performed within the reporting company, including work financed by others." Source: Statistics Canada, *Industrial Research and Development: Intentions*. Technical note 1: Data quality, concepts and methodology: Survey methodology. Catalogue No. 88-202-x, 2015.

[8] Source: Statistics Canada, Institut de la statistique du Québec

SECURING THE FUTURE

We cannot assert that businesses' investment effort has collapsed in recent years, but it has not been lively. Although many of the conditions that would have facilitated investment were in place (including low interest rates, low debt ratios, and rising net profits), spending on machinery and equipment and capital spending did not follow suit. The more uncertain market outlooks and surge in competition played a role that is hard to quantify. Moreover, the fact that business investment must include an increasing level of technology implies more than simply refreshing machinery and equipment: in all sectors, business models and production methods must be upgraded.

Investment in R&D, new technologies, knowledge, expertise and process improvement is critical and comes in addition to material spending. However, these types of investment are very largely self-financed, as they are characterized by less tangible, less transferable assets, and latent uncertainty about their profitability. In addition to the importance of a bigger contribution from outside financing, arrangements fostering tech transfer and industrial research partnerships, investments in training and skill improvement all seem to be as important as equipment in driving the overall transformation of Quebec's economy toward greater productivity.

Business investment is needed in more than one way. Among other things, such investment helps maintain and improve the Quebec economy's competitiveness. Moreover, it creates wealth. That is why so much interest, and hope, is focused there.