BANK OF CANADA
BANQUE DU CANADA

Business Outlook Survey

Results of the Summer 2017 Survey | Vol. 14.2 | June 30, 2017

Responses to the summer *Business Outlook Survey* suggest that business activity is continuing to gain momentum, buoyed by indications that domestic demand will improve further. Positive business prospects are increasingly widespread across regions and sectors.

Overview

- Building on a pickup in sales over the past 12 months, firms expect sales growth to improve further, driven by strength in services and recovering activity tied to the commodity sector. Foreign and domestic demand both provide positive impetus, although risks from potential US policy changes cloud the outlook.
- Although the balance of opinion on investment edged down, plans to increase spending remain widespread and have become more focused on expanding capacity to accommodate stronger demand. Service firms most often cited spending on technology and software. The indicator of hiring intentions, in turn, reached a record high.
- Capacity pressures increased overall, although from low levels in regions tied to energy. Together with rising indicators of labour shortages, responses suggest that slack is being absorbed.
- Despite strong forward-looking indicators of business activity, survey results point to only modest growth in future input and output prices. Inflation expectations edged down and are concentrated in the lower half of the Bank's inflation-control range.
- Credit conditions are unchanged, as most firms saw no change in the terms and conditions for obtaining financing.
- The Business Outlook Survey indicator, which summarizes the survey results, continued to move up to its highest level since 2011, suggesting a broad-based improvement in business sentiment.

The *Business Outlook Survey* summarizes interviews conducted by the Bank's regional offices with the senior management of about 100 firms selected in accordance with the composition of the gross domestic product of Canada's business sector. This survey was conducted from May 8 to June 5, 2017. The balance of opinion can vary between +100 and -100. Percentages may not add to 100 because of rounding. Additional information on the survey and its content is available on the Bank of Canada's website. The survey results summarize opinions expressed by the respondents and do not necessarily reflect the views of the Bank of Canada.

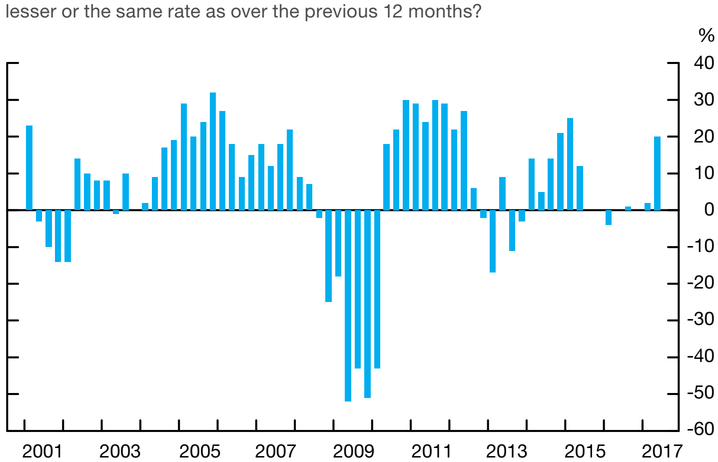
Business Activity

After hovering around zero for nearly two years, the balance of opinion on past sales growth moved up (**Chart 1**), in part owing to the diminishing drag from commodity-related activity. The balance of opinion on future sales increased, mainly because fewer firms anticipate slower sales growth (**Chart 2**, blue bars). Firms generally expect sales growth to continue to build over the coming 12 months. In particular, a positive domestic sales outlook is increasingly widespread across regions and sectors: businesses expect

Chart 1: Past sales growth has finally picked up

Balance of opinion[a]

Over the past 12 months, did your firm's sales volume increase at a greater, lesser or the same rate as over the previous 12 months?



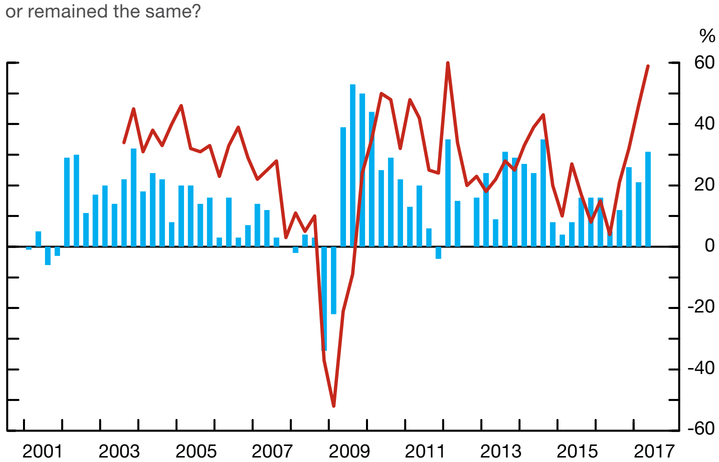
Greater: 43% Same: 35% Lesser: 23%

a. Percentage of firms reporting faster growth minus the percentage reporting slower growth

Chart 2: The improvement in indicators of future sales bodes well for sales growth over the next 12 months

Future sales (balance of opinion)[a]: Over the next 12 months, is your firm's sales volume expected to increase at a greater, lesser or the same rate as over the past 12 months?

Indicators of future sales (balance of opinion)[b]: Compared with 12 months ago, have your recent indicators (order books, advance bookings, sales inquiries, etc.) improved, deteriorated or remained the same?



Future sales: Greater: 50% Same: 32% Lesser: 19%
Indicators of future sales: Improved: 67% Same: 25% Deteriorated: 8%

a. Percentage of firms expecting faster growth minus the percentage expecting slower growth

b. Percentage of firms reporting that indicators have improved minus the percentage reporting that indicators have deteriorated activity to recover in energy-related sectors and to remain high in housing; as well, many respondents see benefits from the low level of the Canadian dollar for their domestic sales because it promotes tourism and dampens competition from US firms. This better sales outlook is underpinned by a solid, broad-based improvement in order books and sales inquiries (**Chart 2**, red line).

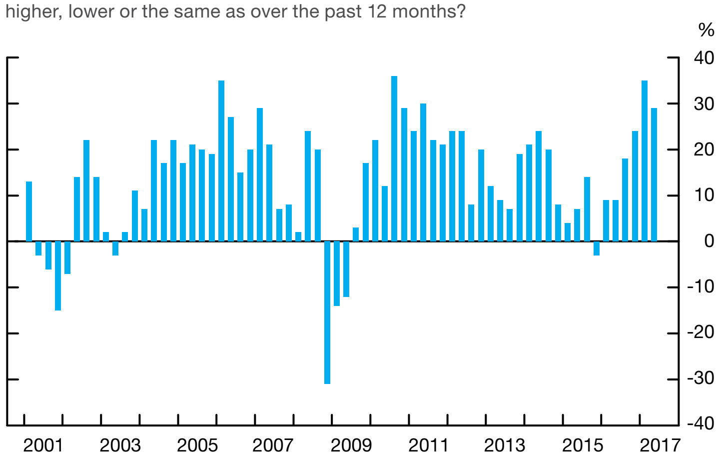
Many firms noted that sustained US demand, backed by a positive business climate, bodes well for their sales outlook. Based on an improvement in orders from foreign customers, firms' expectations for export growth have rebounded somewhat from the modest level recorded in the previous survey. As examples, businesses cited healthy activity in the US construction sector, increased demand for information technology (IT) services and oil, demand from Asia and Europe, and the low level of the Canadian dollar, together with their own efforts to expand into foreign markets.

A number of businesses noted actual or potential benefits, such as stronger US demand for their products, from possible US policy changes, including the Keystone XL pipeline approval and other supportive energy policies. However, the uncertainty around future trade-related negotiations and protectionist measures clouds the outlook for several respondents, who referred to risks such as the adverse effect of higher border taxes on their business or on their clients. In response to the new US policy environment, most affected firms are opting for a wait-and-see approach, with some delaying or changing their expansion plans.

While moderating somewhat from its level in the spring survey, the balance of opinion on investment in machinery and equipment remains elevated and continues to point to an increase in investment over the next 12 months (**Chart 3**). Compared with previous surveys, the focus of firms' investments has shifted toward expanding capacity to accommodate growing sales, with

Chart 3: The balance of opinion on investment intentions remains elevated

Balance of opinion[a]
Over the next 12 months, is your firm's investment spending on M&E expected to be higher, lower or the same as over the past 12 months?



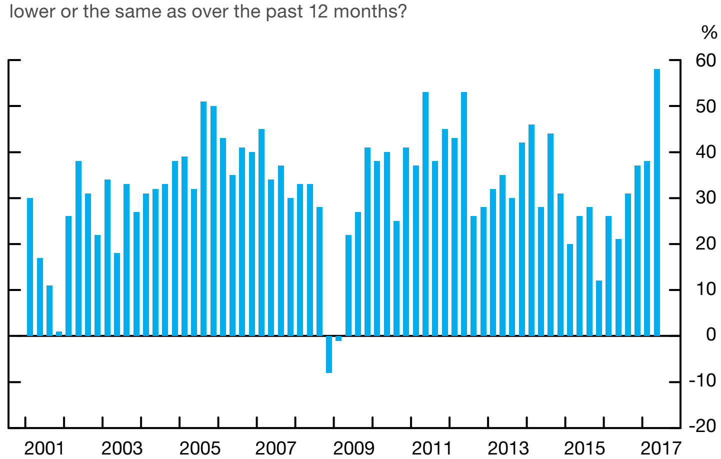
Higher: 48% Same: 34% Lower: 19%

a. Percentage of firms expecting higher investment minus the percentage expecting lower investment

Chart 4: Plans to increase employment are significantly more widespread

Balance of opinion[a]

Over the next 12 months, is your firm's level of employment expected to be higher, lower or the same as over the past 12 months?



Higher: 66%   Same: 26%   Lower: 8%

a. Percentage of firms expecting higher levels of employment minus the percentage expecting lower levels

many businesses referring to improving domestic demand as the main driver of their investment decisions. Service firms frequently cited spending on technology, including IT systems or infrastructure, hardware and software.

The balance of opinion on employment intentions over the next 12 months increased significantly, reaching its highest level on record (**Chart 4**). Positive hiring intentions are broad-based across all sectors and regions, even in energy-producing regions. Firms most frequently mentioned the need to keep up with strong demand and plans to expand their business.

Pressures on Production Capacity

The indicator of capacity pressures moved up and stands above the modest readings over the past two years amid the downturn in the energy sector (**Chart 5**). Respondents signalled that improving demand was the main factor pushing them closer to capacity, and labour-related constraints have become more prevalent (**Box 1**). Capacity pressures are concentrated in British Columbia and Ontario, where robust demand has increased competition for labour, but remain modest in other regions, particularly the Prairies.

Both measures of labour shortages increased (**Chart 6**), suggesting that labour markets are tightening. Somewhat more firms than in the spring survey reported that labour shortages are restricting their ability to meet demand (**Chart 6**, blue bars), although reports of binding shortages are widespread only in British Columbia. The balance of opinion on the intensity of labour shortages (**Chart 6**, red line) rose sharply. This reflects a generalized view among firms that finding labour has become more difficult than it was a year ago, despite still-substantial slack in energy-producing regions.

Chart 5: Capacity pressures increased

How would you rate the current ability of your firm to meet an unexpected increase in demand?

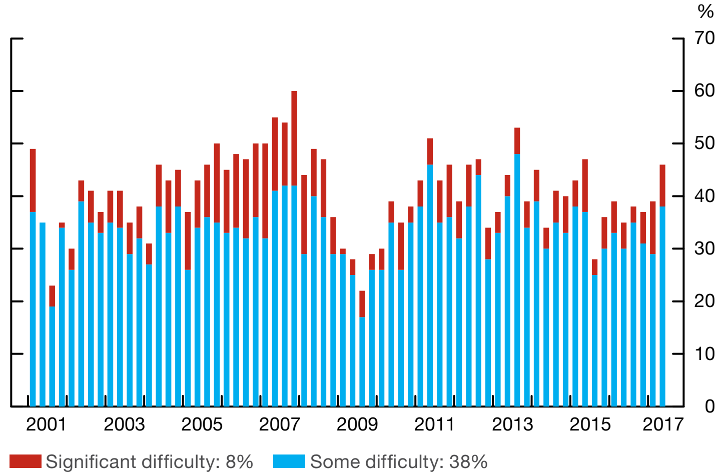
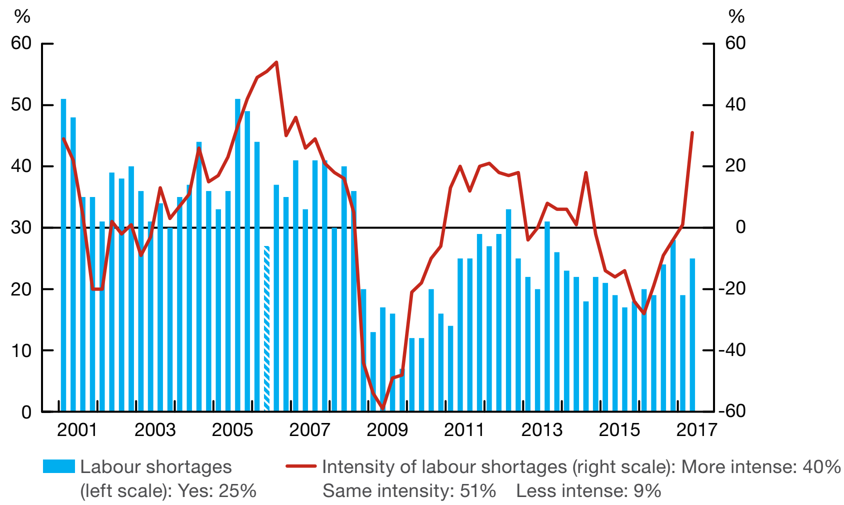


Chart 6: Both indicators of labour shortages moved up, suggesting that slack is gradually being absorbed

Labour shortages: Does your firm face any shortages of labour that restrict your ability to meet demand?

Intensity of labour shortages (balance of opinion)[a]: Compared with 12 months ago, are labour shortages generally more intense, less intense or about the same intensity?



a. Percentage of firms reporting more intense labour shortages minus the percentage reporting less intense shortages

The summer 2006 results are not strictly comparable with those of the other surveys, owing to a difference in the interview process for that survey.

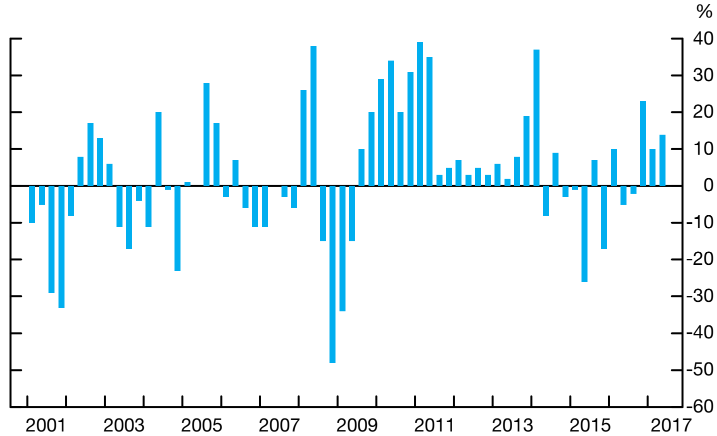
Prices and Inflation

On balance, firms expect input price growth to rise somewhat over the next 12 months (**Chart 7**). Businesses in the goods sector often referred to an expected recovery in commodity prices. A number of firms also mentioned emerging price pressures from other inputs, such as contract labour (related to real estate development, for example), as well as recovering subcontractor costs for firms linked to the energy sector. Nevertheless, wholesale and retail firms expect slower input price growth associated with fading upward pressure from the past depreciation of the Canadian dollar.

Chart 7: Firms expect modest cost pressures over the next 12 months

Balance of opinion[a]

Over the next 12 months, are prices of products/services purchased expected to increase at a greater, lesser or the same rate as over the past 12 months?



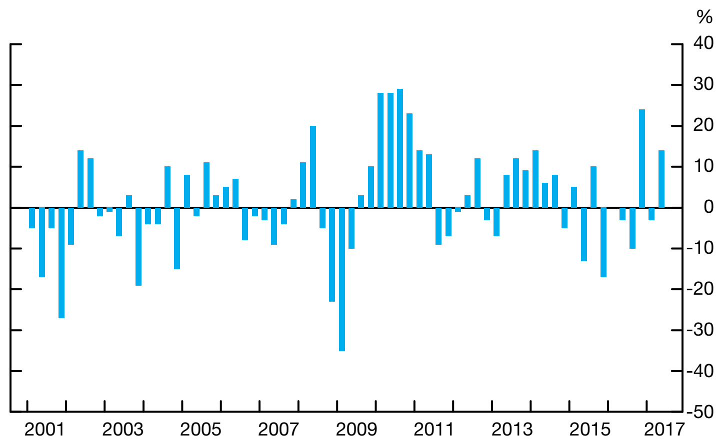
Greater: 36% Same: 43% Lesser: 22%

a. Percentage of firms expecting greater price increases minus the percentage expecting lesser price increases

Chart 8: Output prices are expected to grow at a modestly faster pace

Balance of opinion[a]

Over the next 12 months, are prices of products/services sold expected to increase at a greater, lesser or the same rate as over the past 12 months?



Greater: 37% Same: 41% Lesser: 23%

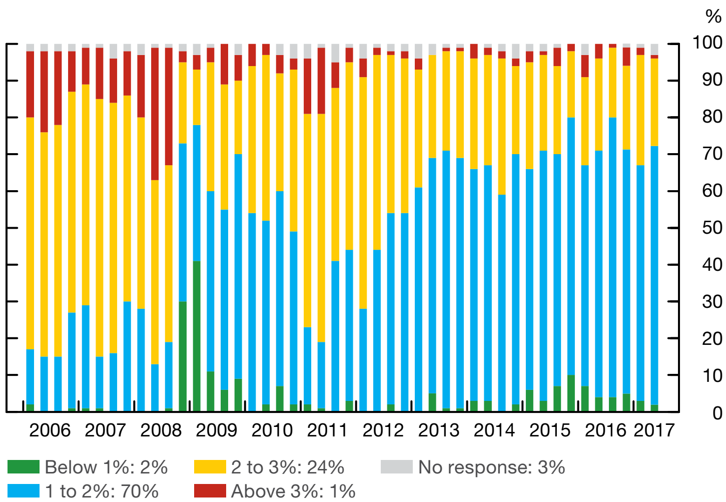
a. Percentage of firms expecting greater price increases minus the percentage expecting lesser price increases

The balance of opinion on output prices turned positive in the summer survey (**Chart 8**), reflecting expectations of modest output price growth over the next 12 months. Firms reported a desire to pass on higher input costs or to rebuild margins as demand recovers. While competition is still restraining the ability of many firms to raise prices, respondents in some sectors now expect some easing of the intense competitive pressures witnessed over the past 12 months.

Expectations for total CPI inflation over the next two years edged down and continue to be concentrated within the Bank's 1 to 3 per cent inflation-control range (**Chart 9**). The majority of firms expect inflation to be in the lower half of the range, representing the widespread view that inflationary pressures will be limited.

Chart 9: Inflation expectations edged down

Over the next two years, what do you expect the annual rate of inflation to be, based on the consumer price index?



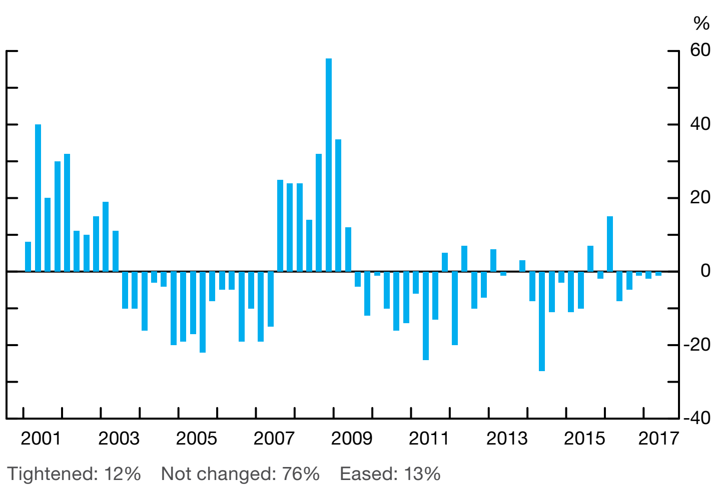
Credit Conditions

For the third consecutive quarter, the balance of opinion on credit conditions remains near zero (**Chart 10**), indicating that the terms and conditions for obtaining financing were unchanged over the past three months. The view that credit conditions are unchanged was widespread across most regions, sectors, firm sizes and sources of financing.

Chart 10: As in previous surveys, credit conditions are unchanged

Balance of opinion[a]

Over the past three months, how have the terms and conditions for obtaining financing changed (compared with the previous three months)?

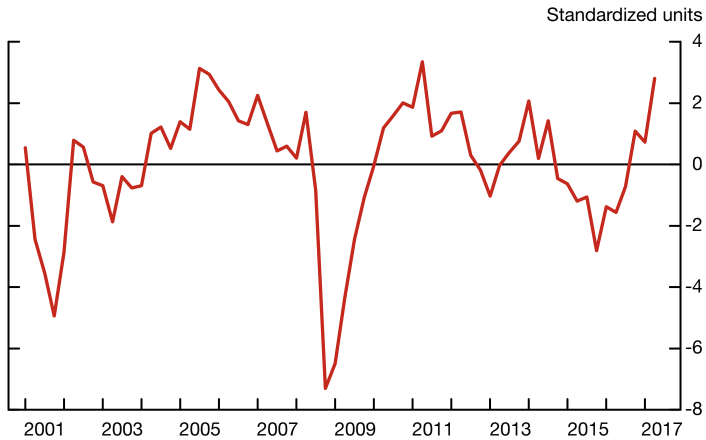


a. Percentage of firms reporting tightened minus the percentage reporting eased. For this question, the balance of opinion excludes firms that responded "not applicable."

Business Outlook Survey Indicator

The Business Outlook Survey (BOS) indicator is a summary measure of the main survey questions and serves as a gauge of overall business sentiment. In the summer survey, it continued to move up after a period of weakness in the wake of the oil price shock (**Chart 11**). Results for nearly all the BOS survey questions are above their historical averages, pushing the indicator to its highest level since 2011. This result provides clear evidence of a generalized improvement in business sentiment.

Chart 11: The BOS indicator[a] moved up, signalling a generalized improvement in business sentiment



a. The BOS indicator extracts common movements from the main BOS questions. For a description and interpretation of the indicator, see Box 1 in the Spring 2017 *Business Outlook Survey* and L. Pichette and L. Rennison "Extracting Information from the *Business Outlook Survey*: A Principal-Component Approach," *Bank of Canada Review* (Autumn 2011): 21–28.

Box 1

Capacity Pressures and Labour Shortages Have Started to Increase

The *Business Outlook Survey* (BOS) includes a series of questions to gauge the extent of pressures on firms' capacity, including any constraints related to labour. The survey questions on capacity pressures (firms' ability to meet an unexpected increase in demand, **Chart 5**) and on labour shortages (**Chart 6**, blue bars) help assess the overall *level* of slack in product and labour markets, respectively. To better understand the *dynamics* of slack, respondents are also asked whether their capacity pressures and their labour shortages are more or less intense than they were 12 months ago. The question on changes in capacity pressures (**Chart 1-A**, blue bars), introduced in the third quarter of 2015, thus mimics the existing question on the intensity of labour shortages (**Chart 6**, red line and **Chart 1-A**, red bars).

Both indicators remained below zero until late 2016, as firms stated that, on balance, pressures on their production capacity had decreased compared with 12 months ago. The results signalled that excess capacity was increasing and that labour was becoming more readily available, as demand was subdued in the context of the downturn in the energy sector.

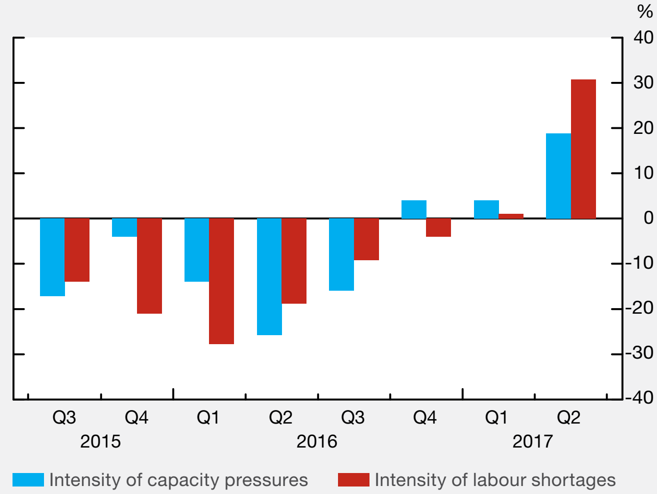
Toward the end of 2016 and in early 2017, both indicators held close to zero, implying that significant slack remained but was no longer increasing. In the summer 2017 survey, firms saw capacity pressures rising, citing stronger demand as the driving factor. Similarly, for the first time in more than two years, results indicate that, in all regions, it has become more difficult, on balance, to find labour.

Although these results, taken together, suggest that excess supply is gradually being absorbed across regions, starting points differ importantly. On the one hand, the energy downturn has left businesses in affected regions still operating with excess capacity. On the other hand, businesses in Central Canada report a gradual tightening, while reports of labour shortages are now widespread in British Columbia. Occupations in short supply range from high- to low-skilled, including IT professionals and experienced staff to compensate for retirements, and construction-related workers (in light of elevated activity in some housing markets).

Chart 1-A: Capacity pressures and labour shortages are more intense compared with 12 months ago

Balances of opinion[a]

Compared with 12 months ago, are capacity pressures (or labour shortages) generally more intense, less intense or about the same intensity?



a. Percentage of firms reporting more intense capacity pressures (or labour shortages) minus the percentage reporting less intense capacity pressures (or labour shortages)

Businesses facing constraints tend to plan on increasing investment and employment in response. Some firms also judge that efforts to retain and compete for labour are starting to feed into wages. Looking ahead, firms anticipate some further tightening in capacity overall, owing to labour-related constraints and improving demand.

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