BANK OF CANADA
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Business Outlook Survey

Results of the Spring 2017 Survey | Vol. 14.1 | 3 April 2017

The results of the spring Business Outlook Survey *reflect signs of a further strengthening of domestic demand following overall subdued activity over the past two years. This outlook is supported by foreign demand and an expected rebound in activity in energy-producing regions.*

Overview

- After a period of weakness, firms expect some increase in sales growth in light of improving indicators of domestic sales. Businesses in energy-producing regions perceive that a recovery is under way.
- Export prospects continue to support the outlook despite elevated uncertainty about the impact of potential US policy changes, notably corporate tax cuts and protectionist measures.
- Although many firms expect additional spending to be modest, intentions to increase investment have become more widespread, driven by strengthening demand. Hiring intentions remain positive overall.
- Pressures on capacity are still modest as excess capacity persists, notably in the Prairies. Firms expect a gradual tightening in capacity along with firming demand. Indicators of labour shortages suggest that labour market slack remains but is no longer widening.
- Firms anticipate little momentum in input and output prices because of still-important competitive pressures. Inflation expectations remain concentrated in the lower half of the Bank's inflation-control range, although they have edged up marginally.
- Most firms reported no change in the terms and conditions for obtaining credit, and access remains easy or relatively easy overall.
- Taken together, the results suggest a modest recovery in business sentiment after a two-year period of weakness, as summarized by the Business Outlook Survey indicator (**Box 1**).

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 13 February to 9 March 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.

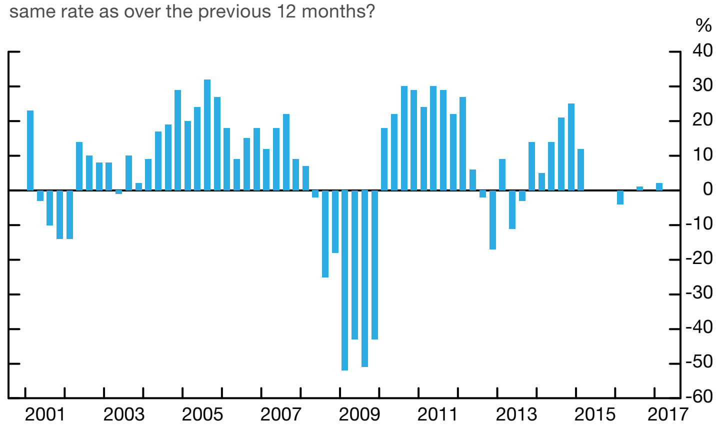
Business Activity

On balance, firms reported that sales growth has been stable over the past 12 months (**Chart 1**). The balance of opinion of close to zero continues to mask a divergence between the Prairies, where sales growth slowed, and the rest of the country, particularly Ontario and British Columbia, which experienced stronger growth.

Although firms have, on balance, not seen an increase in past sales growth for nearly two years, they remain optimistic that sales will grow at a somewhat faster pace over the next 12 months (**Chart 2**, blue bars). This expectation is supported by improving indicators of future sales, such as new orders (**Chart 2**, red line), particularly in the service sector. The balance of opinion

Chart 1: Sales growth has been stable over the past 12 months...

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?

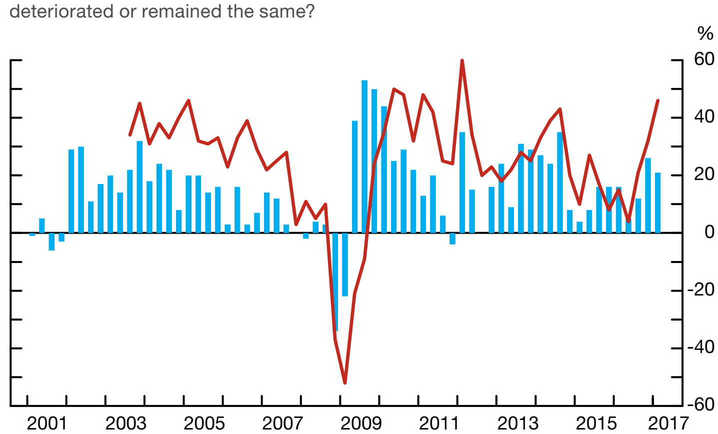


Greater: 41% Same: 20% Lesser: 39%

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

Chart 2: ...and firms anticipate some firming of sales growth ahead

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: 52% Same: 17% Lesser: 31%
Indicators of future sales: Improved: 61% Same: 24% Deteriorated: 15%

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

reached its highest level in five years and indicates that, by a solid margin, businesses across the country saw better indicators of future sales than 12 months ago.

The sales outlook is increasingly supported by domestic sales perspectives along with the expected rebound in energy-related activity. Respondents also referred to the favourable effects of the weaker Canadian dollar for exports and the tourism sector. Meanwhile, some firms believe that activity in sectors experiencing robust growth (such as housing and automobiles) could soon level off.

Export prospects continue to support the outlook. Firms anticipate somewhat faster export growth, in light of improving indicators of future sales from foreign customers. A growing number of firms expect US growth to be strong, citing the new US administration's plans for expansionary policies and a related improvement in confidence. As in previous surveys, many respondents, especially manufacturers, believe that the positive US outlook will bring some export opportunities.

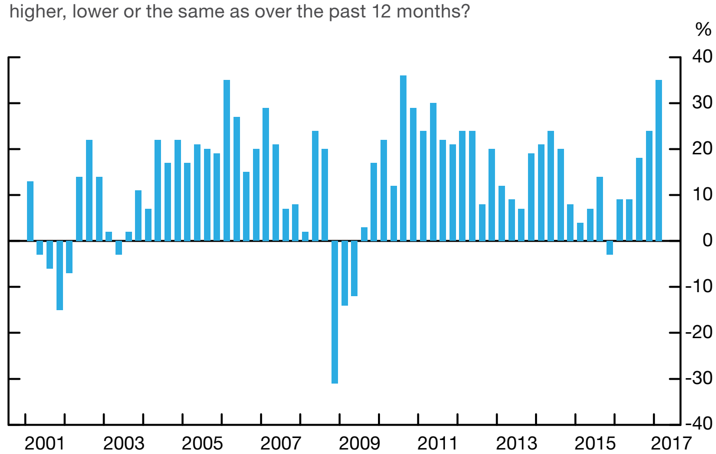
Nevertheless, firms remain wary in an environment of elevated uncertainty about potential US policy changes. Although to date only a few firms have seen concrete effects, several see negative risks. These risks include increased protectionism, reduced competitiveness of Canadian firms in the event of corporate tax cuts in the United States, and possible delays in the implementation of pro-growth US policies. On the upside, some firms perceive possible benefits in relation to, for example, the Keystone XL pipeline and, in the longer term, potential infrastructure spending.

The balance of opinion for investment in machinery and equipment continued to increase after a two-year period of weakness (**Chart 3**). Many firms expect the increase in expenditures over the next 12 months to be modest, and several are limiting investment to maintenance items. Yet, the result suggests that plans to invest in Canada have become more widespread, buoyed by firming domestic demand.

Chart 3: Intentions to increase investment are becoming more widespread...

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?



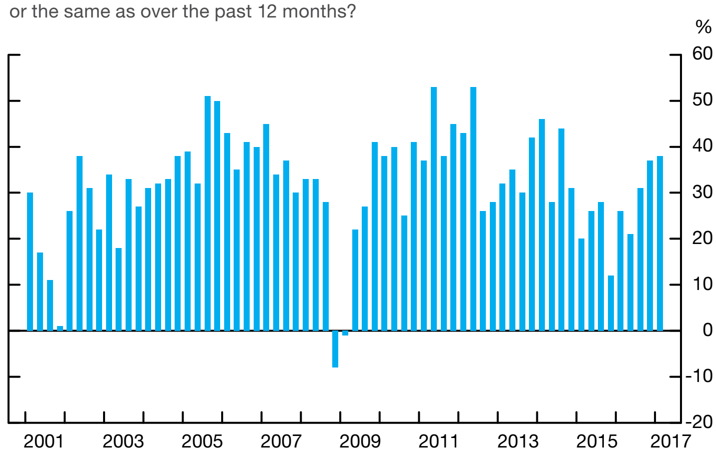
Higher: 46% Same: 43% Lower: 11%

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

Chart 4: ...while firms, on balance, plan to add jobs over the next 12 months

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: 52%   Same: 34%   Lower: 14%

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

Similar to the winter survey, exporters, on balance, are positive regarding investment. The spending behaviour of firms in regions hit by the oil price shock is also recovering, supported by improving commodity prices and business confidence. This increase in investment intentions partly reflects a modest catch-up after a period of cuts.

The indicator of employment intentions is positive and similar to the winter survey (**Chart 4**). On balance, firms in all sectors and regions plan to add jobs over the next 12 months. Consistent with improving indicators of future sales, many firms plan to add staff to accommodate the anticipated increase in demand. Yet, a small number of firms are planning staff reductions because of a lack of activity or to achieve productivity gains.

Pressures on Production Capacity

Capacity pressures remain modest overall, suggesting that slack persists (**Chart 5**). Firms in the Prairies still refer to material excess capacity. The share of firms reporting that they would have difficulties meeting an unanticipated increase in demand is roughly unchanged from the winter survey, although more firms cited significant difficulties. Firms expect some emerging pressures on capacity going forward, with many referring to firming demand as the driving factor.

On balance, businesses view labour shortages as having the same intensity as 12 months ago (**Chart 6**, red line). While the near-zero balance of opinion suggests that labour market slack remains, the indicator has continued to improve gradually since the oil price shock, as conditions in affected regions have bottomed out. Businesses in other regions, particularly in British Columbia, reported increasing difficulties in finding labour.

The number of firms reporting that labour shortages are restricting their ability to meet demand decreased somewhat, returning to the levels observed since 2014 (**Chart 6**, blue bars). Some firms mentioned that inter-provincial workers returning from the oil patch help alleviate such shortages.

Chart 5: Capacity pressures remain modest...

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

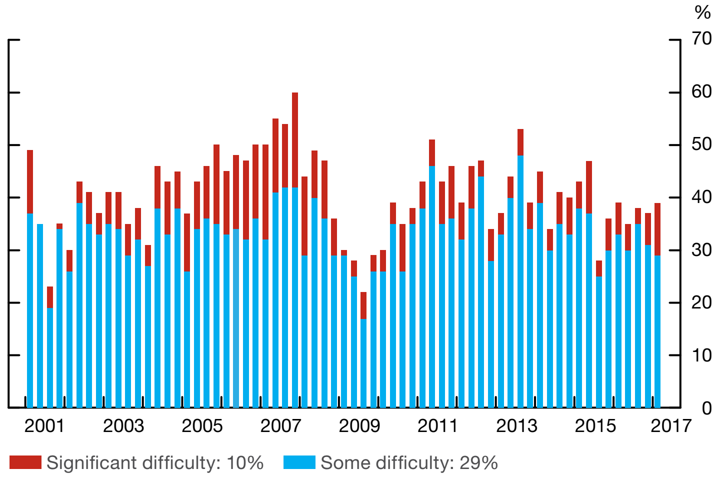
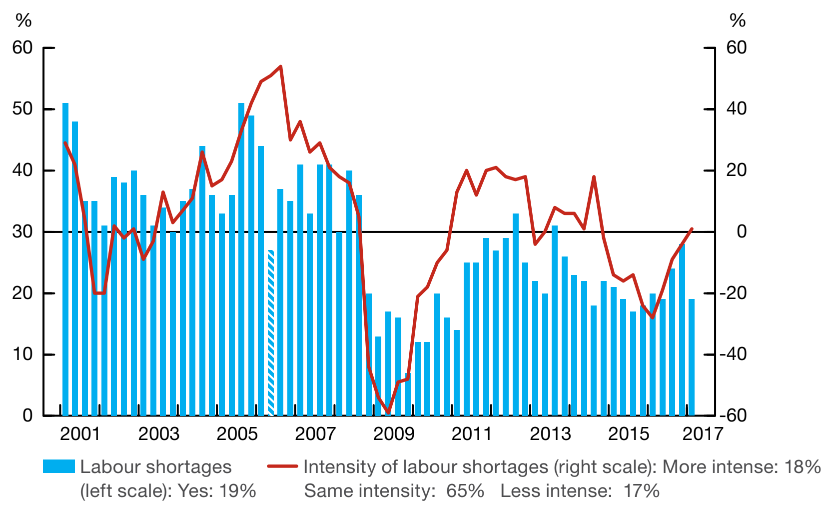


Chart 6: ...and indicators of labour shortages suggest that labour market slack remains

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.

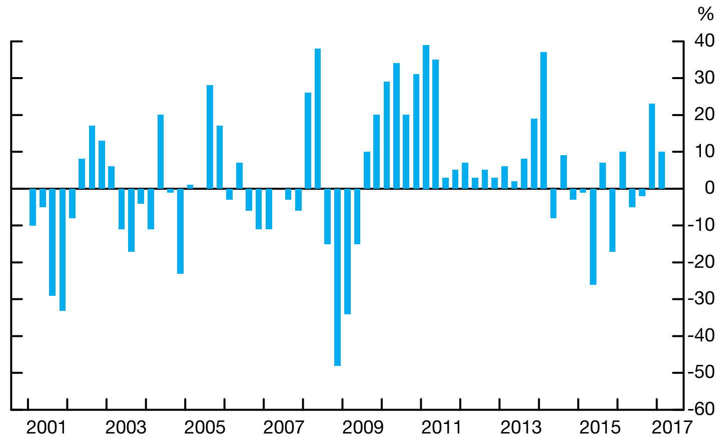
Prices and Inflation

Input prices are expected to grow at a marginally faster pace over the next 12 months, as indicated by the positive, but low, balance of opinion (**Chart 7**). Firms anticipate that higher commodity prices will add to cost growth. A few also cited regulatory factors, such as cap-and-trade policies in Ontario and the carbon tax in Alberta, as contributing to their input price growth. At the same time, past exchange rate depreciation is now largely built into prices for imported inputs. Some respondents also indicated that their favourable bargaining power helps restrain growth in input costs, since they can actively seek out the most cost-competitive suppliers.

Chart 7: Firms expect slightly faster input price growth...

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?



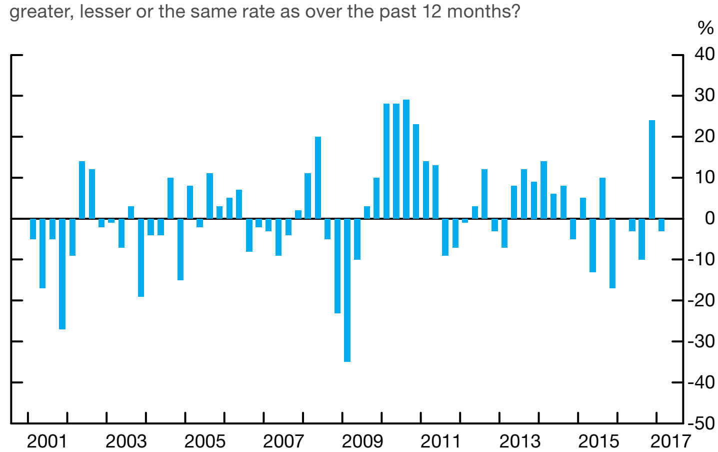
Greater: 30% Same: 50% Lesser: 20%

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

Chart 8: ...and output price growth to be stable

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: 23% Same: 51% Lesser: 26%

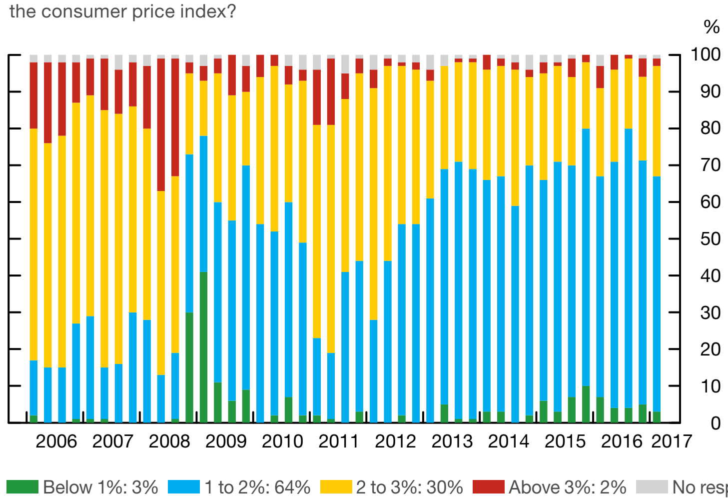
a. Percentage of firms expecting greater price increases minus the percentage expecting lesser price increases

On balance, firms expect output price growth to be stable over the next 12 months (**Chart 8**). Firms cited several factors dampening price growth, including still-weak demand from commodity-linked customers, competitive pressures and limited bargaining power, particularly for those supplying large retailers. Others expect that gradually firming demand will allow them to pass on some cost increases, such as higher commodity prices, to their customers.

Inflation expectations remain modest, with the majority of firms continuing to expect inflation to be in the lower half of the Bank's inflation-control range (**Chart 9**). Firms view slow growth as the main reason for weak price pressures. Overall, inflation expectations are marginally higher than in the winter survey: higher commodity prices and expected inflationary pressures in the United States are viewed as contributing to domestic inflation over the next two years.

Chart 9: Inflation expectations remain modest

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

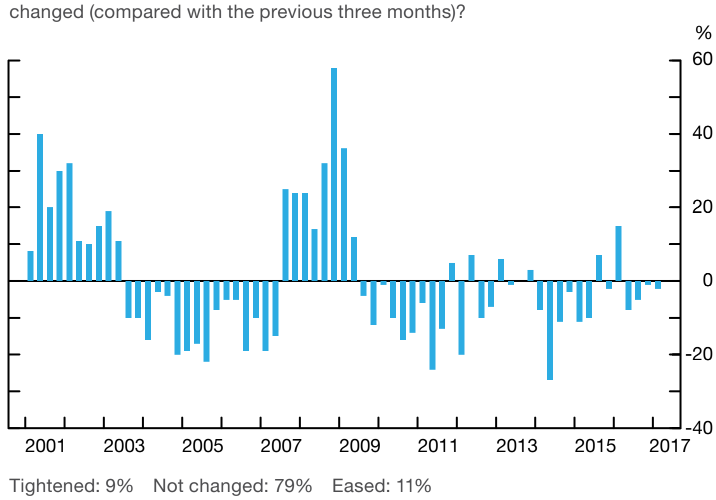


Credit Conditions

The balance of opinion on credit conditions remains near zero, suggesting that the terms and conditions for obtaining financing are unchanged (**Chart 10**). A widespread majority of firms report no change in their overall financing conditions, while those linked to commodities see a gradual improvement in their access to credit. That said, a few firms observed a tightening in the form of higher borrowing rates, which some associated with the recent increase in US long-term rates.

Chart 10: 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."

Box 1

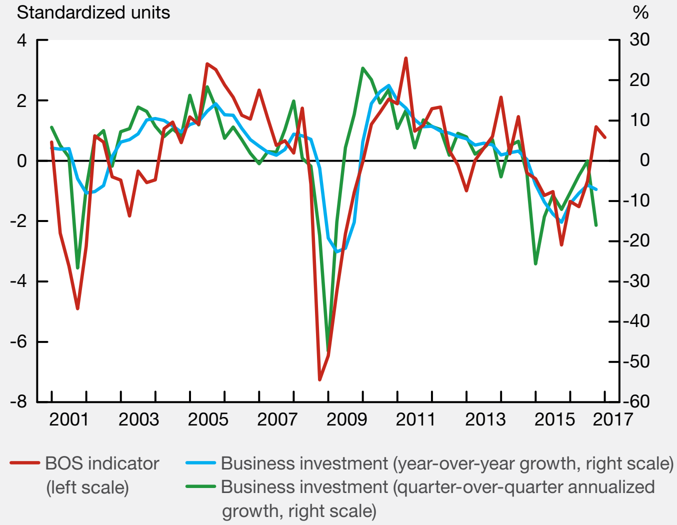
The Business Outlook Survey Indicator Points to a Modest Recovery in Business Investment

While individual survey questions in the *Business Outlook Survey* (BOS) provide useful insights into specific aspects of business activity, a summary measure of the main survey questions serves as a gauge of overall business sentiment. The BOS indicator extracts common movements from the main BOS questions.[1] It tracks investment growth reasonably well (Chart 1-A) and provides early signals of trends and turning points in economic activity. Moreover, simple forecast models using the indicator provide current-quarter estimates of growth in business investment and gross domestic product. As such, it serves as a timely complement to the Bank of Canada's monitoring and forecasting of economic activity.

The BOS indicator illustrates the slowdown in business activity in late 2014 triggered by the oil price shock. The indicator fell below zero, i.e., below its historical average, although not as sharply as in the recession of 2008–09. It remained negative for two years, consistent with the contraction in business investment over that period. The BOS indicator began to recover starting with the 2016–17 winter survey, as the complex adjustment of the Canadian economy to low commodity prices slowly progressed. This swing in the indicator into positive territory is associated with improving business sentiment from a weak level, rather than with generalized strength, and points to a modest pickup in business investment growth in the near term.[2]

Chart 1-A: The BOS indicator suggests a modest recovery in business sentiment after a two-year period of weakness

Quarterly data



Sources: Statistics Canada and Bank of Canada

Last observations: Business investment, 2016Q4; BOS indicator, 2017Q1

1 For a technical discussion of the indicator and an assessment of its forecasting performance, see L. Pichette and L. Rennison "Extracting Information from the *Business Outlook Survey*: A Principal-Component Approach," *Bank of Canada Review* (Autumn 2011): 21–28 and L. Pichette and M.-N. Robitaille, "Assessing the Business Outlook Survey Indicator Using Real-Time Data," Bank of Canada Staff Discussion Paper No. 2017-5 (April 2017).

2 Business investment in the fourth quarter of 2016 continued to contract, partly reflecting a reversal of the one-off boost to third-quarter growth from the arrival of an imported production module destined for the Hebron offshore oil project. Since the BOS indicator does not capture such special factors, it visibly diverges from investment growth in that quarter.

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ISSN 1916-4076