BANK OF CANADA
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Business Outlook Survey

Results of the Spring 2016 Survey | Vol. 13.1 | 1 April 2016

Business sentiment in the spring Business Outlook Survey *improved but remains subdued overall. The positive impetus coming from sustained foreign demand continues to be largely offset by the persistent drag and spillovers from the oil price shock.*

Overview

- Firms' perspectives continue to diverge sharply, depending on whether they are tied to the commodity sector and on their exposure to foreign demand. Expectations for future sales growth remain positive, with clear signs of support from U.S. demand. Yet the outlook for domestic sales is guarded in light of sluggish demand and the ongoing adjustment to lower oil prices.
- Investment and employment intentions have increased but remain modest, with balances of opinion masking a sharp split among firms. Those linked to the energy sector report that they are curtailing investment expenditures as they continue to adapt to challenging conditions, while firms facing foreign demand, particularly exporters not tied to commodities, indicate stronger intentions.
- Capacity pressures edged up slightly, and few firms anticipate significant difficulties meeting an unexpected increase in demand. Indicators of labour market shortages still point to widespread slack, most prominently in the Prairies.
- Firms expect input prices to increase at a slightly greater rate, and output price growth to stabilize. Inflation expectations increased slightly but remain concentrated in the lower half of the Bank's inflation-control range.
- Credit conditions tightened, largely reflecting the effects of the oil price shock.

Business Activity

The balance of opinion on past sales is little changed in the spring survey and, at close to zero, suggests a flattening of sales growth over the past 12 months, dampened by lacklustre sales activity among firms linked to the resource sector (**Chart 1**). The positive balance of opinion on future sales is unchanged from the previous two surveys, pointing to an acceleration in sales volumes over the next 12 months (**Chart 2**). Firms' sales perspectives continue to diverge sharply. Although survey results suggest that the negative effects of the oil price shock are starting to level off, firms tied to the energy sector still face a difficult environment. Several domestically oriented firms expect outright declines in their future sales volumes as the downturn in the commodity sector hampers

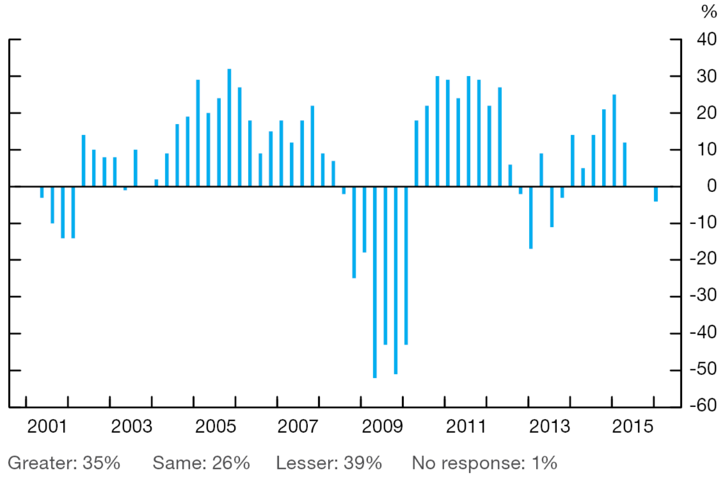
The *Business Outlook Survey* summarizes interviews conducted by the Bank's regional offices with the senior management of about 100 firms selected in accordance with the composition of the gross domestic product of Canada's business sector. The spring 2016 survey was conducted from 11 February to 7 March 2016. 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.

broader business activity across regions and sectors (see **Box 1** for a discussion of the effects on firms of lower oil prices and the past depreciation of the dollar).[1]

Chart 1: Firms saw a flattening of sales growth 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?

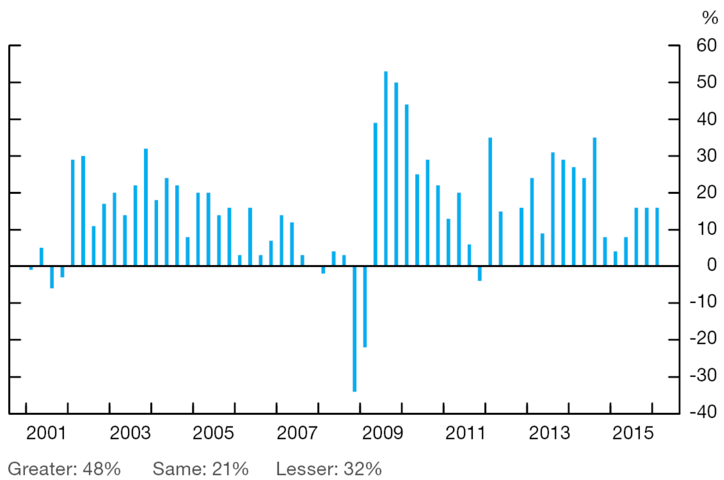


a. Percentage of firms reporting faster growth minus the percentage reporting slower growth

Chart 2: ...and expect an acceleration in sales volumes over the next 12 months

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?



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

Nonetheless, sustained foreign demand and gains in competitiveness due to the past depreciation of the Canadian dollar continue to boost firms' sales prospects overall. The net improvement from a year ago in indicators of future sales, such as advance orders and sales inquiries, was attributed to demand from foreign rather than domestic customers, and export sales growth is expected to outpace that of domestic sales over the next 12 months. While respondents' expectations of U.S. economic growth have moderated somewhat from previous surveys, and some view the U.S. outlook as more uncertain, more than half of firms report that U.S. demand is providing a lift to their sales outlook. This group includes firms already exporting to the United States,

1 The results reported in the box are based on special survey questions that firms were asked in addition to the standard questions. The Bank regularly includes special questions, on a temporary basis, to examine topics of current interest.

as well as those in the process of refocusing their sales efforts to regain market share abroad or to seize new sales opportunities, since the past depreciation of the Canadian dollar renders such strategies more viable.

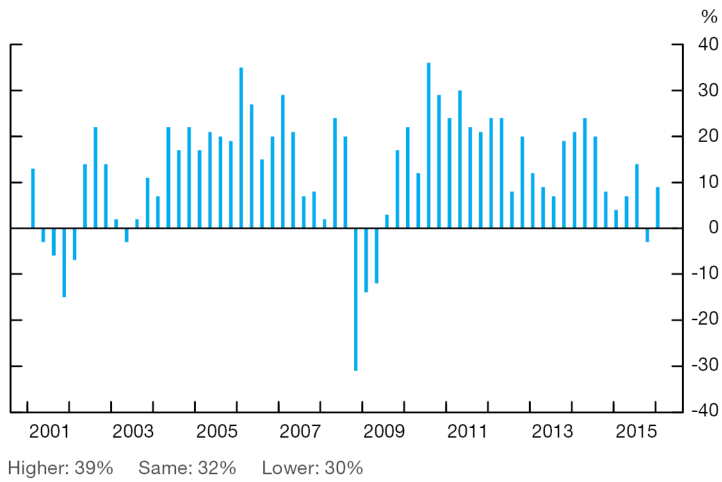
The balance of opinion on investment in machinery and equipment moved back into positive territory in the spring survey (**Chart 3**), suggesting overall modest increases in investment expenditures over the next 12 months. Investment intentions continue to diverge. On the one hand, firms in the energy supply chain and those exposed to weakening demand in affected regions continue to report plans to curtail investment expenditures. More generally, the lack of momentum in domestic demand remains the primary reason cited for holding back investment, while some respondents also pointed to difficulty accessing capital or their weak financial position.

On the other hand, there are increasingly tangible signs that businesses exposed to foreign markets, including firms in various service industries such as tourism and information technology, intend to boost their investment expenditures to take advantage of solid international demand.

Chart 3: Firms' investment intentions have increased but remain modest...

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?



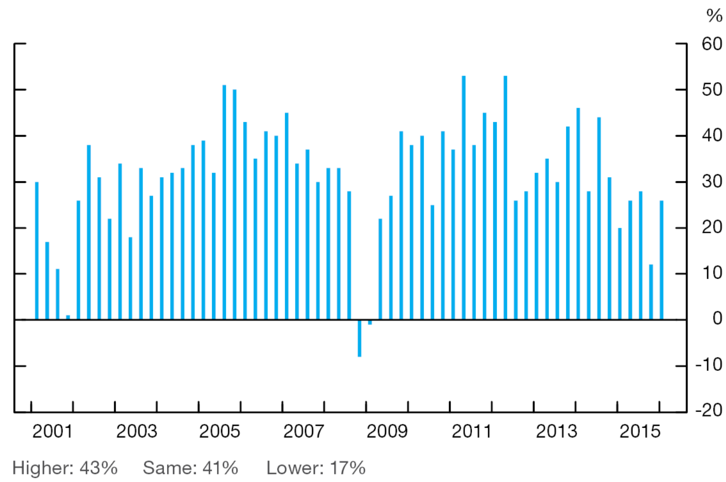
a. Percentage of firms expecting higher investment minus the percentage expecting lower investment

Employment intentions improved from the low reading in the previous survey but remain below the historical average (**Chart 4**). This result points to somewhat more widespread hiring intentions over the next 12 months, particularly among exporters not tied to the commodity sector and firms in service industries. Businesses often linked plans to increase their workforce to the need to accommodate capacity expansion and firmer demand for their products. On the downside, the slump in the energy sector continues to weigh on employment intentions. Planned layoffs and hiring freezes remain disproportionately high for firms in the Prairies. Others justified anticipated workforce reductions by pointing to declining sales volumes, while a number of firms also sought to become more efficient with their current level of staff.

Chart 4: …while employment intentions have improved

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?



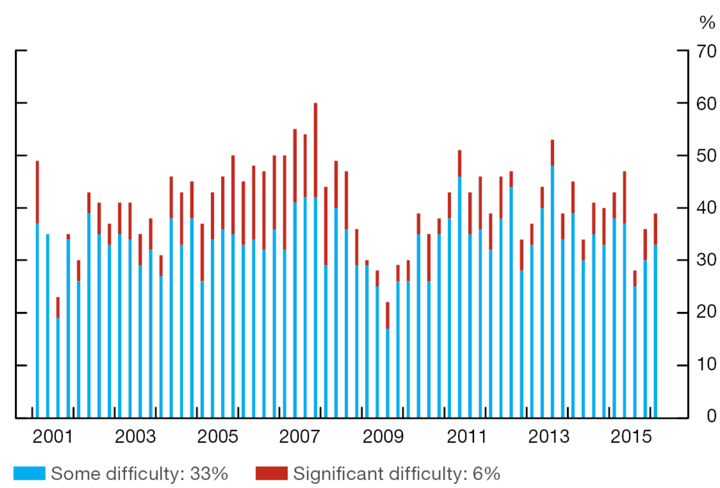
a. Percentage of firms expecting higher levels of employment minus the percentage expecting lower levels

Pressures on Production Capacity

Capacity pressures have edged up slightly since the winter survey (**Chart 5**), with few firms anticipating "significant" difficulty meeting an unexpected increase in demand. Respondents frequently pointed to physical capacity constraints as a key obstacle to meeting a sudden rise in demand, while reports of insufficient labour were less frequent. Businesses in the Prairies continued to indicate abundant spare capacity, citing weak demand and the greater availability of labour as a result of layoffs in the commodity sector. Capacity pressures remain more prevalent among exporters and manufacturing firms.

Chart 5: Capacity pressures edged up slightly in the spring survey…

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

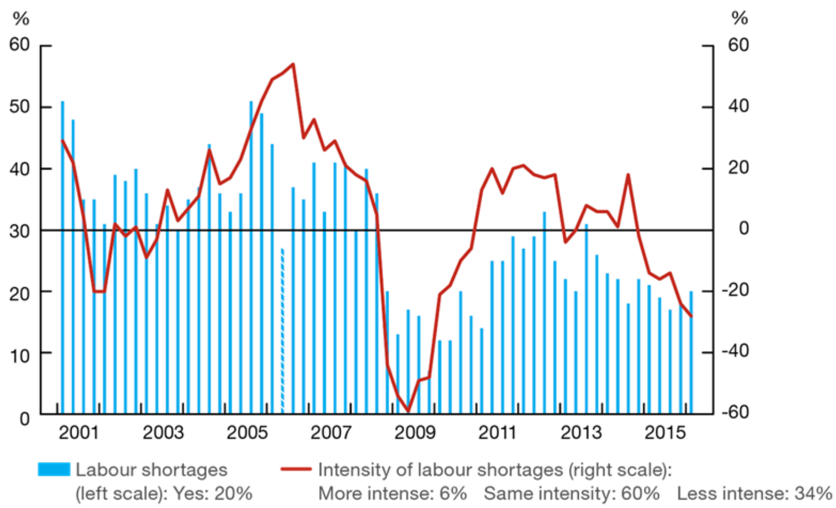


The number of firms reporting labour shortages that would restrict their ability to meet demand remains low, similar to the past few surveys (**Chart 6**, blue bars). The indicator of labour shortage intensity is below zero (**Chart 6**, red line), suggesting a widespread view among businesses that shortages are less intense than they were a year ago. These findings indicate substantial and persistent labour market slack across all sectors. Excess labour supply remains most prominent in the Prairies, although interprovincial labour shifts are becoming more evident. Many firms reported that workers returning from the oil patch because of layoffs are starting to become available elsewhere.

Chart 6: ...but indicators of labour shortages continue to point to persistent slack

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

Labour shortage intensity (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.

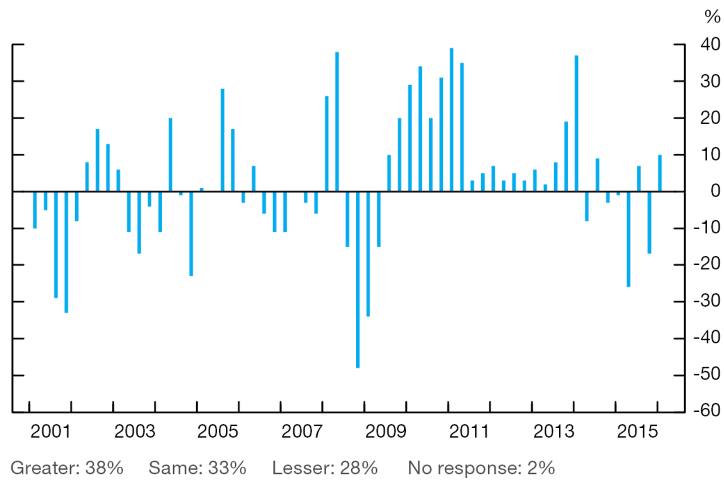
Prices and Inflation

The balance of opinion on input prices turned positive in the spring survey, indicating that firms anticipate a modest acceleration in the prices of their inputs over the next 12 months (**Chart 7**). Many firms consider that commodity prices are bottoming out and thus expect less downward momentum or small increases in the cost of their commodity-related inputs. Another key driver of input price momentum was the past depreciation of the Canadian dollar. While businesses continue to see some lagged effect on the prices of their imported inputs, they increasingly judge that most of the adjustment has already taken place and thus expect less upward pressure on input prices over the next 12 months.

Chart 7: Firms anticipate a modest acceleration in the prices of their inputs…

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?



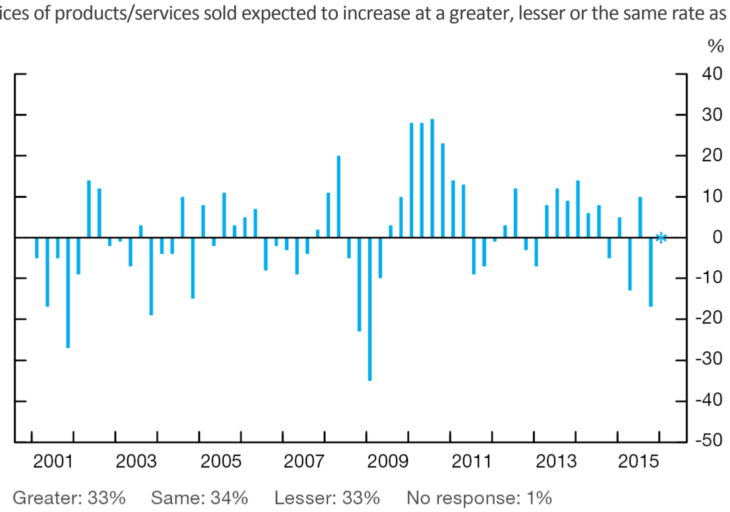
a. Percentage of firms expecting greater price increases minus the percentage expecting lesser price increases

On balance, firms expect their output prices to increase at a similar pace over the next 12 months to that of the past 12 months, as indicated by the zero balance of opinion. Several businesses have already passed on the lower costs of commodity-related inputs to their customers and expect such inputs to exert upward pressure on their prices going forward. At the same time, firms expect the effects of the past depreciation of the Canadian dollar to dissipate, since they have already adjusted their output prices in response to higher costs for imported inputs. Some noted that longer pricing cycles or expired hedging strategies will imply further pass-through from the exchange rate, although at a slower pace. A number of firms also referred to intense competition as a factor restraining their ability to raise prices.

Chart 8: …and expect their output prices to increase at a similar pace to that of the past 12 months

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?



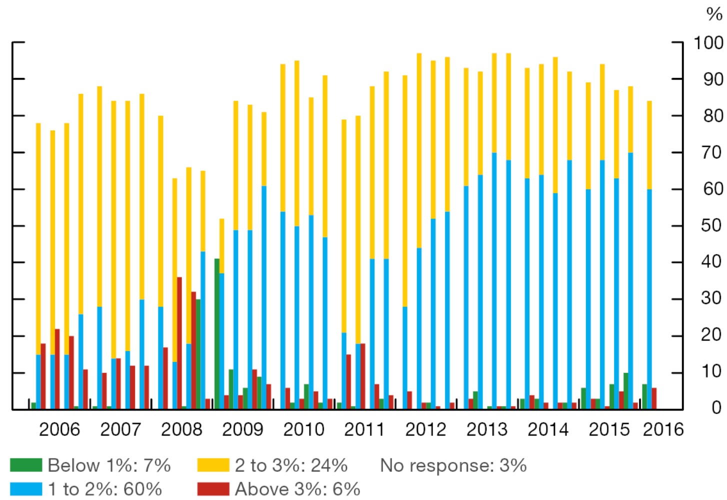
a. Percentage of firms expecting greater price increases minus the percentage expecting lesser price increases
* Indicates a balance of opinion of zero

Inflation expectations edged up in the spring survey (**Chart 9**). The majority of firms anticipate that, over the next two years, total CPI inflation will be in the bottom half of the Bank's 1 to 3 per cent inflation-control range.

Businesses often attributed lower inflation expectations to soft oil prices and sluggish economic growth. Others pointed to the weaker Canadian dollar—which is making imported products, notably food, more expensive—and an eventual recovery in oil prices as the main reasons for higher inflation expectations.

Chart 9: Inflation expectations moved up slightly

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



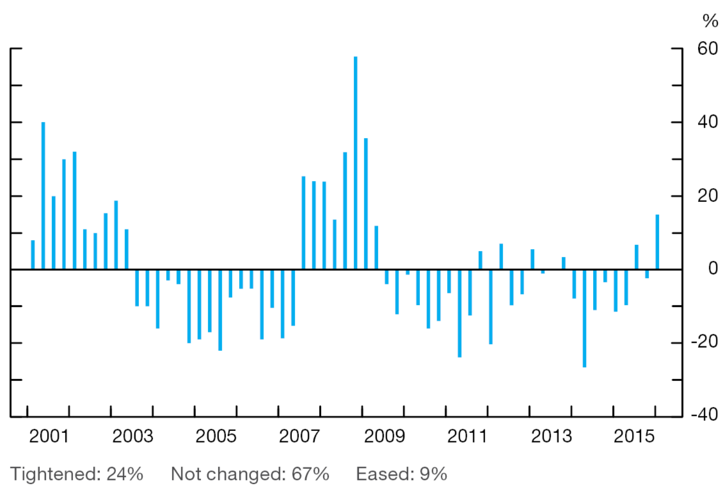
Credit Conditions

Businesses reported a net tightening in credit conditions over the past three months, as indicated by the positive balance of opinion (**Chart 10**). Firms citing tighter conditions primarily experienced an increase in borrowing costs, as well as a deterioration in their ability to issue new debt. Reports of tightening were concentrated among firms with direct or indirect exposure to the energy sector. Fewer respondents than in previous surveys cited an easing in credit conditions. Despite the uptick in the indicator on credit conditions, most firms continue to characterize credit as easy or relatively easy to obtain.

Chart 10: Credit conditions tightened, largely reflecting the effects of the oil price shock

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 conditions. For this question, the balance of opinion excludes firms that responded “not applicable.”

Box 1

How Firms Are Affected by Lower Oil Prices and the Depreciation of the Dollar

Since mid-2014, major global economic developments have led to both lower oil prices and a weaker Canadian dollar vis-à-vis the U.S. dollar. Firms participating in the spring *Business Outlook Survey* were asked about the impact of these developments on their business. The results suggest that the effects are multi-faceted and evolving as firms adjust to this new environment.

With respect to the lower Canadian dollar, the majority of surveyed firms, including many in the service sectors, are seeing increasingly tangible benefits (**Chart 1-A**). Exporters, including several manufacturers, are receiving higher Canadian-dollar prices for their products sold abroad, boosting their margins. Moreover, in Canadian markets, some firms have benefited from less competition from their U.S. counterparts. Firms related to tourism and retail trade also saw a lift to their sales volumes, since Canadians now tend to travel and spend more in Canada. Yet the weaker currency puts significant pressure on the cost structure of many firms with a sizable share of their input costs and machinery and equipment costs denominated in U.S. dollars.

Many firms view lower oil prices as unfavourable to their outlook (**Chart 1-B**). In particular, businesses in the energy sector and those closely tied to it, such as manufacturers supplying machinery and service companies dependent on business activity in the sector, are struggling. Beyond the energy supply chain, many firms reported being indirectly hit, indicating important spillover effects across sectors and regions. For example, firms in the construction industry and service-oriented firms, such as those in finance, as well as a number of retailers, faced negative indirect demand effects. Nevertheless, for other respondents, weaker oil prices are somewhat helpful because they are reducing transportation costs and fuel surcharges, as well as the cost of other commodity-related inputs, including utilities. Businesses linked to transportation also noted a boost to their sales volumes.

While numerous firms have adopted a "wait-and-see" approach, many are adapting to the new environment. Most commonly, firms reported refocusing their sales efforts here and abroad. Several exporters have become more competitive in the United States by cutting the U.S.-dollar prices of their products to increase their market share, while others plan on entering foreign markets. Some firms also reported plans to redirect their sales toward growth prospects in domestic markets shielded from the oil price shock. A number of firms are now focusing more on their Canadian operations, particularly as the price of labour in Canada has become more competitive. Others reported replacing more expensive foreign inputs with Canadian inputs. Among firms tied to the energy sector, many reported taking drastic actions to cope with weaker revenues, including layoffs, wage freezes, rollbacks and major cuts to investment budgets.

Chart 1-A: Effects of the lower Canadian dollar on firms

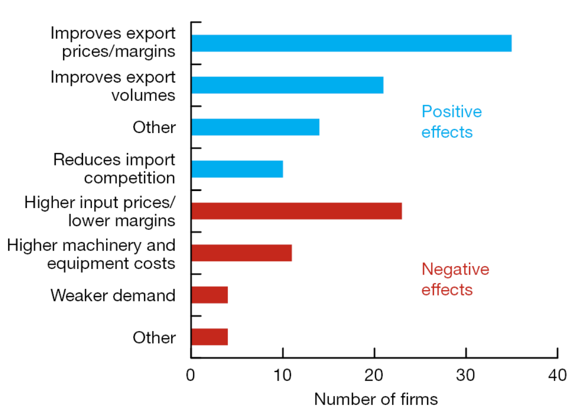
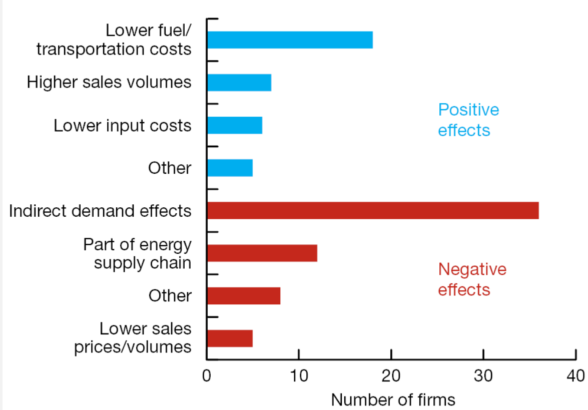


Chart 1-B: Effects of weaker oil prices on firms



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