Supply chain risk and the construction sector in Canada

QBE

Introduction

Canada faces a complex year ahead, with looming political tensions, geopolitical rivalries, and economic woes threatening to weaken the business climate. Already far outlasting the average for most minority governments, Prime Minister Justin Trudeau will have to overcome yet another potential government corruption scandal and manage conflicting pressures from within his party and from provincial governments.

The US-China strategic rivalry continues to escalate, providing both opportunities in Canada as near-shoring and supply chain policies favour North American markets, but also escalating trade risks as bilateral relations between Canada and China continue to deteriorate.

Underlying all of this is a potential looming recession amidst high inflation rates, high housing prices, and concerns regarding affordability and access to healthcare. Supply chains within Canada still remain highly vulnerable, both to disruptions in the transportation sector domestically and to broader supply chain disruptions driven by conditions in the United States and globally. Although elections are still unlikely this year, these pressures will also likely limit government investment to areas of highest priority – namely healthcare, consumer prices, and energy – limiting investments in other areas. This high level of uncertainty is likely to mean that resilience – especially to disruptions in the supply chain – will be of key importance to successful businesses.

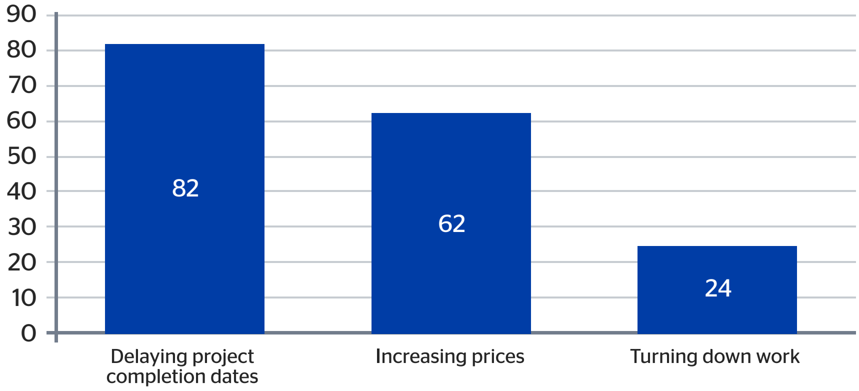
A shortage of material inputs has been one of the largest factors constraining construction in Canada

How important is supply chain risk for construction firms?

Supply chain issues are currently one of the top concerns for Canadian construction firms. In a survey published by the Independent Contractors and Businesses Association in January 2023, 58% of Canadian construction firms said they expected supply chain issues to be a challenge in 2023.[1] Only shortage of skilled labour was cited more often. This follows earlier survey evidence for 2022 in which 76% of companies reported they experienced delays in obtaining construction materials for their projects.

The construction firms were also asked in the January 2023 survey about how materials shortages were impacting their business. Over 80% of companies had been forced to delay project completion dates due to long wait times for materials. Almost 25% had turned down new work opportunities due to the inability to acquire the inputs necessary to complete the project, as shown in Figure 1.

Figure 1: How are construction companies coping with supply chain issues



Source: IBCA

Another way at investigating the impact of the supply chain shortages on construction firms is by running a scenario through a large-scale macroeconomic model. The results suggest that construction output in Canada was 2% below the level it otherwise would have been in 2022, as firms struggled to obtain the necessary materials to complete ongoing contracts and win new ones. The scenario results for 2023 suggests the supply disruption is likely to lower construction output by 1½% below the level it otherwise would have been.

Canada sources almost 20% of its total imports of construction inputs from China. This dependence on China is higher than Canada's European counterparts (Germany, France, Spain, Italy, the UK, and the Nordics). Countries across the globe are still dealing with supply chain disruption as a result of China's Covid-19 policies, and ongoing heightened geopolitical tension may cause further issues even as China loosens its restrictions.

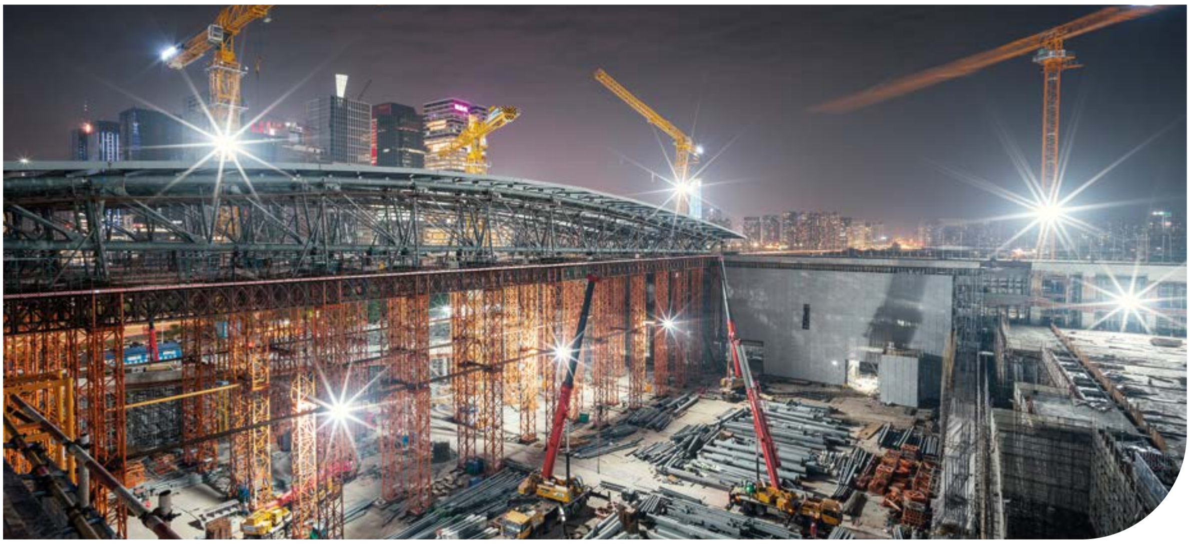
Being reliant on one, or few, countries is not the only potential bottleneck in Canada's supply chain. The same is true for mode of transport of material imports. For trade with the US this is usually not an issue, as most of the goods

1. ICBA-Winter-202223

are transported by road. However, Canadian trucker strikes in 2022 due to Covid vaccination mandates proved that despite being considered a safe transport method, disruptions are still possible. Imports from China and other overseas countries, however, will enter via sea or air. For example, the proportions of the following inputs imported by sea are: parquet flooring (81%), worked marble (85%), and reinforcing steel (70%). If air or sea transport links—or the hubs through which goods pass—experience issues, Canadian construction firms may be left without vital supplies.

Key things to watch

- **Political stability:** Minority governments in Canada tend to last on average approximately two years, with the previous election in 2021 having delivered a win for Trudeau with yet another minority government. While the NDP has promised to support Trudeau on all supply and confidence votes, providing an unusual degree of stability for a minority government, it will be particularly vulnerable in 2023 due to increased economic pressures, yet another high-profile corruption scandal, and demands from the NDP for its continued support.
- **North American trade:** Canada potentially stands to benefit from a range of policies taken in the US to bring supply chains back to North America, especially for key strategic products across numerous sectors, including extractives and technology. However, the framework underpinning North American trade – the USMCA – now faces severe tests to its dispute resolution mechanism. Although thus far seemingly successful, current disputes are in areas politically sensitives to all three countries – the preceding NAFTA's dispute resolution infamously failed spectacularly, only resolving three disputes between 1993 and 2000, before the mechanism became deadlocked for the rest of its existence. Should USMCA succeed at dispute resolution, businesses can expect greater long-term stability and Canada will be able to rely on the USMCA as a safeguard against US protectionism.
- **US-China decoupling:** Canada is likely to increasingly be pulled towards the US in the ongoing US-China economic decoupling, both due to the dependence of the US and Canada on each other and due to deteriorating bilateral relations between Canada and China over a range of issues, including accusations of Chinese interference in Canadian elections. This is likely to spur regulatory and trade restrictions ranging from further investment restrictions on national security grounds to export restrictions on sensitive technologies or advanced components. These issues risk sparking broader trade wars, which can increase costs in other areas, including in the construction sector.



Our central forecast

Our central forecast is for construction output to decline every quarter throughout 2023, with the annual decline totalling 6%. The sector continues to struggle with a shortage of skilled labour and supply chain issues. Residential construction is expected to post the largest decline of all sub-sectors, of 6.8%, as the sector contends with a major house price correction and rising mortgage rates. Recent analysis by Oxford Economics found Canada's economy to be the most vulnerable economy to a global 10% fall in residential investment, a daunting but plausible scenario. Canada's residential investment declined in Q2 and Q3 of 2022, while house prices plummeted over 13% between February and the end of the calendar year. Furthermore, non-residential building and civil engineering activity are both expected to record contractions in 2023, of 3.2% and 6.1% respectively.

Construction output is predicted to decline every quarter in 2023

Figure 2: Canada construction output

Source: Oxford Economics

What can construction firms do to lower supply chain risk?

Firms can invest resources into gaining market intelligence and developing relationships with the alternative suppliers available to them. The ability to flexibly shift operations to different suppliers offsets some of the risks presented by being overly dependent on a single supplier if they face unforeseen challenges. The same is also true for different modes of transport or particular routes and hubs (like ports) for imports, and for importing from different geographical areas. Having contingency plans in place for negative scenarios may prove beneficial.

Implementing technology throughout the supply chain to integrate previously separate processes may be a source of competitive advantage for firms, by streamlining and simplifying the procurement of materials and inputs. Furthermore, technology can be used to remove human error. For example, setting up a system to automatically order supplies when stocks reach a certain level.

Forward thinking firms may use the recent increases in the price of input materials as a turning point in the way they structure their contracts. Being tied into fixed-price contracts during times of economic uncertainty and large price fluctuations can lead to projects ultimately becoming unprofitable. Adopting cost escalation clauses as standard avoids this issue, by allowing firms to share the additional expenses incurred when input prices rise.

Finally, firms may need to revise the method they use to operate their supply chain timeline. In times of economic stability, "just in time" has proved effective by reducing inventory levels and storage costs. However, in times of unpredictability, a "just in case" method of holding greater inventory levels may be a safer option. If supply chains are disrupted and inputs become difficult to acquire, firms holding greater stocks will be better positioned to continue their operations.

This report has been developed for QBE by **Control Risks** and **Oxford Economics**

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