The Canadian and World Economic Situation and Outlook

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After registering strong growth in 1999 and through most of 2000, the Canadian economy slowed significantly in 2001. Real growth in Canada's Gross Domestic Product (GDP) increased 5.1% in 1999 and 4.4% in 2000 although, by the fourth quarter of 2000, it had slowed to an annual rate of 3.5%. This slowdown in the growth of the economy has continued through the first half of 2001 as the annual rate of increase decelerated to 2.5% in the first quarter and 2.1% in the second. The reduced growth exhibited this year is due largely to the weakening U.S. economy. Real GDP growth in the United States has not reached an annualized rate of even 2% since the second quarter of 2000 and, in the third quarter of 2001, declined by a preliminary rate of 0.4%.

The shocking terrorist attacks on the United States on September 11 and the events that have unfolded since will have significant negative economic consequences for both Canada and the United States for at least the next several months. In an effort to bolster the U.S. economy, the U.S. Federal Reserve Board has been aggressively cutting interest rates and both President Bush and the U.S. House of Representatives have passed fiscal stimulus packages centring on tax cuts. The Bank of Canada has also cut interest rates substantially in 2001 but, other than some modest tax cuts, further fiscal stimulus in Canada is unlikely as government revenues slow and increased expenditures on security measures and the military may not leave much room for additional fiscal measures. Under the present circumstances, economic growth in Canada for the rest of 2001 will likely be slightly negative, resulting in a growth rate for the whole of 2001 of about 1%. Growth is expected to pick up gradually through 2002, especially during the second half, resulting in a real rate of increase of about 1.5% for the year.

Canada's inflation rate averaged 2.7% in 2000. For the first nine months of 2001, the Consumer Price Index (CPI) has averaged 3.0%. High energy prices caused the rate to rise to 3.6% in the second quarter of 2001, but the rate has since moderated to an average of 2.7% in the third quarter. The core rate (which excludes the effects of energy and food prices), however, has remained remarkably steady, averaging just over 2% so far in 2001. For the year 2001, the all items CPI should average about 2.8% as the economy, operating below capacity, will produce rates near 2% by the end of the year with rates remaining at about that level through 2002.

The Bank of Canada's target for the overnight rate stood at 5.75% at the end of 2000. As evidence mounted that both the U.S. and Canadian economies were slowing, the Bank instituted a series of 25- and 50-point rate reductions (0.25% and 0.50%) through the first part of 2001. After the events of September 11 and as further evidence of a waning economy accumulated, the Bank cut the target rate for the eighth time by an aggressive 75 basis points, bringing the overnight rate in October 2001 to 2.75%, the lowest level in about 40 years. The chartered banks' prime business rate also declined by 75 points to 4.5%. The cuts have not had an appreciable effect as yet, but they are intended to underpin business and consumer confidence and provide additional support for domestic demand growth through 2002. With the Canadian economy expected to continue to weaken along with its U.S. counterpart, and as inflation ceases to be a concern, the Bank is likely to trim another 75 points off the target rate before this easing cycle ends.

The Canadian dollar has been undermined by the poorly performing U.S. economy, subsequent weakness in the Canadian economy, the global slowdown, and a continuing decline in commodity prices. Other factors may be financial market unease following the September 11 attacks and a potential Argentine default on some of its debt payments. Against other currencies, however, the dollar has not fared too badly. Since its lows in 1998, the Canadian dollar has gained against the euro, the British pound, the Swiss franc and the Australian dollar. After averaging about US$0.674 over the 1998-2000 period, the dollar averaged about US$0.649 for the first 10 months of 2001. In the wake of several unfavourable indicators coming from the United States at the end of October, the dollar sunk to an all-time low relative to the U.S. dollar, trading at under

US$0.63. In times of uncertainty and poor economic conditions, investors tend to invest in a “safe haven,” which now is the U.S. dollar. The Canadian dollar, which continued to set new lows against the U.S. dollar in early November, will likely remain in the doldrums under US$0.63 for the rest of the year. The Canadian dollar should fare moderately better next year as signs of recovery in the United States and Canada begin to appear and as global demand for raw materials improves.

Even before the terrorist attacks in September, the Canadian economy was showing signs of slowing. It managed only a 0.4% annualized advance in the second quarter of 2001, its poorest performance since the third quarter of 1995. In addition to weakness in business investment and exports, both of which were becoming evident earlier in the year, consumer spending grew at only a 1.1% pace in the second quarter. Early third-quarter data on retail sales suggests that consumer spending remains subdued – a 0.3% increase in August offset a 0.3% decline in July. Sales by auto dealers, furniture stores and clothing stores have softened, which may indicate consumers are cutting back on discretionary purchases. Canada’s export sector is affected by shrinking U.S. demand, and business investment is affected by falling corporate profits and flagging business confidence. Business investment is expected to increase by only about 0.6% in 2001 and by about 1.7% in 2002 compared to 6.6% in 2000. Corporate profits, which increased almost 22% in 2000, are expected to increase by about 4.4% in 2001 and remain flat in 2002. A Statistics Canada business conditions survey, conducted quarterly to test manufacturers’ plans for production and employment, showed companies more pessimistic in October 2001 than at any time since 1990/91.

Canada’s unemployment rate declined steadily over the 1997-2000 period, dropping from an annual average of 9.2% in 1997 to 6.8% in 2000. The rate has averaged a little over 7% so far in 2001 but, with job losses expected to increase for the remainder of the year, the rate should average about 7.2 or 7.3% for 2001. The labour picture, combined with falling equity markets, indicates that consumer spending in Canada will remain soft.

Canada’s construction sector, by contrast, seems to be weathering the downturn in economic activity relatively well. Housing starts are expected to reach about 158 000 in 2001 compared with about 152 000 in 2000. Lower mortgage rates, a relatively low inventory of new buildings, and firm home prices have helped support this sector. Housing starts may decline in 2002, however, as the economic slowdown continues through the first part of the year.

Canada’s merchandise exports fell to their lowest level in 17 months in August 2001 (the latest month for which data are available). Exports have been generally declining since January 2001 when they reached a record $38.4 billion. Imports in August declined slightly to $29.7 billion, leaving a trade surplus for August of $4.4 billion, the lowest surplus since April 2000. However, the cumulative merchandise trade surplus for the first eight months of 2001 stood at $48.3 billion, about $11.3 billion higher than for the same period in 2000. The most notable drop in exports in August occurred in exports to the United States, but shipments to all major regions of the globe also faltered. The short-term export picture is not bright. The events of September 11 have caused delays across the Canada-U.S. border, and the terrorist attacks have caused continuing weakness in the U.S. economy as well as in many of Canada’s other major trading partners. Another concern is the tariff and duty penalties the U.S. government has imposed on softwood lumber exports from Canada. The two penalties (a 19.3% tariff imposed in August and a further duty averaging 12.6%) means the effective rate of duty is now up to 32%. Softwood lumber exports to the United States have dropped 10% since the countervail duty was imposed.

The lower Canadian dollar has, to some extent, helped the export sector. To the extent the dollar is lower, exporters are able to charge more in Canadian dollars than if the dollar were stronger and, as Canadian goods become cheaper for foreign buyers, they have an incentive to purchase Canadian goods. The opposite is true for importers. Higher costs (in Canadian dollars) cannot always be passed on to consumers in the current economic environment. Also, a weaker currency means costs, such as raw material costs, become more expensive for exporting companies.

The U.S. economy has been slowing for several quarters with the weakness becoming much more evident in the second and third quarters of 2001. After posting a respectable 4.1% real growth in GDP in 2000, growth declined to an annualized quarterly rate of 1.1% in the first quarter of 2001 and only 0.3% in the second. For the first time since early in 1993, the U.S. economy shrank in the third quarter of 2001. Preliminary figures released by the U.S. Department of Commerce indicate that the U.S. economy contracted by an annual rate of 0.4 % during that quarter. A fourth-quarter contraction seems increasingly likely as well. In an effort to counteract this weakening trend, the U.S. Federal Reserve cut interest rates nine times in 2001 by a total of 350 basis points. Because inflationary pressures are subdued, the Federal Reserve has room to continue cutting the interest rates, which is what it is expected to do one or two more times in 2001. In the third quarter, business investment in new plant and equipment declined at an annual rate of 11.9%, the third consecutive quarterly drop. Consumer spending rose, but at a feeble rate of 1.2%, the poorest showing since early 1993. Other recent indicators pointing to the deteriorating economic situation in the United States include: orders to factories for durable goods fell in September for the fourth consecutive month; the number of Americans filing claims for unemployment benefits in late October reached its second highest level in nearly a decade; and U.S third-quarter corporate profits plunged an average of 21% on average compared to the third quarter of 2000.

In addition to the Federal Reserve's interest rate reductions in 2001, the U.S. government has initiated a substantial fiscal stimulus package. In August, the Administration announced a US$30 billion tax cut and rebate program that takes effect over the last half of 2001. The Administration also announced the allocation of US$40 billion to disaster relief, defence, intelligence and other anti-terrorist efforts. These funds will be dispersed through the end of 2003 with most to be spent in 2002. Another US$5 billion in direct subsidies and US$10 billion in loan guarantees to the airline industries is forthcoming in the fourth quarter of 2001. President Bush is also urging the speedy passage of an additional US$100 billion stimulus package that, as of early November, was being debated in the House.

While the impact on economic growth of these monetary and fiscal measures will be modest at best for the rest of 2001, the boost to the U.S. economy in 2002 will likely be substantial and supports the case for a meaningful rebound in economic growth during the latter part of 2002 and through 2003. For the whole of 2002, real growth should approach about 1.5% although, towards the latter part of the year, real growth above 3% is anticipated. This rate may be expected to continue through 2003. If this turns out to be the case, the Federal Reserve may move to a more restrictive monetary position in 2003.

A major downside risk with these scenarios is the impact of the September 11 terrorist attacks. Repercussions from those events are still unfolding. Future attacks or other disruptions cannot be ruled out. Even the threat of attacks or perceived threats will undoubtedly shake the confidence of both consumers and businesses. Two reports released in early November reinforce this view. The National Association of Purchasing Management said its monthly factory index fell to its lowest level since early 1991. New orders and production both fell. In the other report, the U.S. Department of Commerce stated that personal spending in September declined 1.8%.

The terrorist attacks are also expected to take a toll on global economic output. With the U.S. economy expected to contract over the last half of 2001, world economic growth seems set to drop to just over 2% in 2001, compared to a growth rate of 4.8% in 2000. A major contributor to this slowdown has been a decline in world trade, which has dropped since the beginning of the year in line with the U.S. slowdown. While few regions are expected to escape the effects of the attacks, Latin America and the emerging economies of Asia may suffer the most as they are still emerging from the economic and financial crises of a few years ago.

Japan is attempting an ambitious program of financial and fiscal restructuring. Even before the events of September 11, and assuming that the restructuring would be successful, the outlook for Japan was for growth to remain below 1% for several years. With the more pessimistic world outlook, Japan may be expected to register negative growth over the next two years. If the forces against restructuring prevail, Japan can expect a more prolonged stagnation.

The weakness of the Japanese economy, combined with reduced U.S. demand for their information technology (IT) products, has caused a significant deterioration in the IT-exporting countries of Taiwan, South Korea, Hong Kong and Singapore, where their combined growth rate is expected to decline from over 8% in 2000 to less than 1% this year. South Korea, alone among these countries, should experience reasonable growth this year and next due to its more diversified export base and stronger domestic demand. Other Asian countries are weathering the storm better due to their lower reliance on high-tech exports, but even they are being affected. Civil and political tensions in some of these countries add to their concerns.

China seems to have escaped much of the turmoil affecting much of the rest of the world. Real growth in China should remain above 7% through 2003 at least.

The European Central Bank's modest interest rate response to the economic downturn will not likely prevent growth in the euro-zone from falling to below 2% in 2001 from almost 3.5% in 2000.

The financial crisis facing Argentina has eased somewhat with the recent US$8 billion International Monetary Fund loan. The loan will likely enable Argentina to meet its financial needs for the rest of 2001, although short-term financing pressures are likely to return next year. Mexico is being greatly affected by the U.S. slowdown. Eighty-five percent of Mexico's exports are destined for the United States. As a result, growth in Mexico is expected to decline to less than 1% in 2001 from nearly 7% in 2000.

In Russia and other Commonwealth of Independent States (C.I.S.) energy-exporting countries, the combination of higher oil prices and sharply depreciated exchange rates led to a surge in real GDP growth to 8.6% in 2000. In 2001, C.I.S. GDP growth is projected at 4.4%, 3.5% lower than in 2000. The decline in 2001 largely reflects the partial reversal of the factors that boosted growth earlier – real exchange rate appreciation, weaker-than-expected activity in Western Europe, and lower energy prices.

Note: Information in this article was current as of November 2, 2001.

Sources: Bank of Canada, October 23, 2001 Press Release, *Remarks by Governor of the Bank*, October 24, 2001; Canada Mortgage and Housing Corporation, Press Release, May 2, 2001; International Monetary Fund, *World Economic Outlook*, October 2001; Statistics Canada, *The Daily*, October 19, 2001, Canadian International Merchandise Trade, October 22, 2001, retail trade; TD Economics, *Quarterly Economic Forecast*, September 26, 2001; *Policy Response to Terrorist Attack*, October 5, 2001; TD Economics Commentary, October 19 and October 23, 2001; Comments and reports on aspects of the Canadian and world economic situation and outlook in *The Globe and Mail Report on Business*, *The Financial Post* and *The Ottawa Citizen*.