The Canadian and World Economic Situation and Outlook

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The Canadian economy has performed well so far in 2002 and is expected to lead all G7 countries in growth in both 2002 and 2003. After registering a real growth rate of only 1.5% in 2001, the economy, as measured by the annualized rate of change of real Gross Domestic Product (GDP), forged ahead by 6.2% in the first quarter and 4.3% in the second quarter of 2002. Economic growth is likely to slow somewhat during the second half of the year to about 2.5%, resulting in a growth rate of about 3.5% for 2002 as a whole. For 2003, a respectable growth rate of 3-4% may be expected. These figures contrast with those of the United States. Excess capacity and reduced consumer spending in the United States resulted in a weak growth rate of 1.3% in the second quarter (following a 5.0% growth rate in the first quarter). Aggressive interest rate reductions by the Federal Reserve Board in 2002 should, however, lay the groundwork for a recovery in the U.S. economy through 2003.

The most striking feature of Canada's economic performance in 2002 was job creation. While the number of people entering the labour force kept the unemployment rate averaging 7.7% through October, the Canadian economy created a very impressive 459 000 full- and part-time jobs through the January-October period of 2002, compared to only 13 000 created during the whole of 2001. This fact, coupled with a real increase of over 3% in personal disposable income through the first half of 2002, provides support for consumer spending and a strong base for continued growth in the domestic side of the Canadian economy.

Another highlight of Canada's economic performance is the recovery of the business sector. Pre-tax corporate profits have risen by an annualized rate of about 50% for each of the first two quarters of 2002. This has contributed to a sharp increase in investment in machinery and equipment – an annualized rate of almost 21% in the second quarter. With capacity utilization rates rising, business investment is set to expand over the next few quarters.

In an attempt to head off a downturn in the economy in 2001, the Bank of Canada instituted a series of 10 interest rate reductions, lowering the Bank's trend-setting overnight target rate from 5.75% in January of 2001 to just 2.00% at the end of the year. As economic prospects improved, and in an attempt to contain any inflationary pressures that might arise, the Bank began raising rates in January 2002 to the present level of 2.75%. The rate has held steady at this level since July.

Inflation rates have increased somewhat through the third quarter and into the fourth. The year-over-year All Items Consumer Price Index (CPI) ranged from a low of 1% in May to 1.8% in March before breaching the 2% mark in July. Indications are that the rate will continue to increase over the next few months and will likely average somewhat more than 2% for the year. The increases are, however, largely the result of a series of one-off price movements that do not reflect underlying price pressures. When the price of a good spikes in one month, the inflation rate will increase that month and will continue to show up in the year-over-year CPI rate in subsequent months – it reflects a one-time jump and not a general increase in the rate at which prices are rising (the same applies when the price of a good declines).

The CPI rose 3.2% in October 2002 compared to the October 2001 level (0.3% compared to September 2002). Increases in the price of cigarettes (due to higher federal and provincial taxes), auto insurance premiums and energy prices accounted for almost all of the year-over-year rise. This spike in the October rate, compared to the 2.3% registered in September, is not as drastic as it appears. It is largely due to what Statistics Canada refers to as the "base effect."[1] The "base effect" in this case skews the year-over-year comparison upward. This effect will also skew the November rate upward.

The Bank of Canada is more concerned with the core inflation rate, which excludes eight volatile items as defined by the Bank. This rate is currently running at about 2.5% – in the upper half of the Bank's target range

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[1] For an explanation of the Base effect, see the November 21, 2002, issue of Statistics Canada's *The Daily*, available on the Internet at www.statcan.ca.

of 1-3%. The rate is expected to increase further in the months ahead and may approach the upper limit of the target range. Two factors contributed significantly to the increased core rate, both of them the one-off variety. First, energy prices in Ontario increased sharply as a result of deregulation of the electricity market. Second, auto and home insurance premiums increased sharply in several provinces during the year. While the Bank stated that it is monitoring the inflation front carefully, it is aware that the increases are not yet due to underlying price pressures. This factor, plus the guarded outlook for the economies in the United States, Europe and Japan, as well as the aggressive interest rate cuts in the States, indicate the Bank will be reluctant to raise interest rates in the near term. However, as the Canadian economy begins to perform above potential and as the global outlook improves, interest rate increases may be expected near the middle of 2003.

(Note: On November 11, 2002, the Ontario government announced that it was freezing electricity rates at 4.3 cents per kilowatt-hour, the rate that prevailed prior to deregulation. This will reduce the rate of increase in inflation starting with the December figure).

Perhaps the brightest light in a generally bright economic picture is the Canadian housing market. The industry is benefiting from the strong job and income growth mentioned above, combined with low mortgage rates. In October 2002, housing starts reached 220 400 units, compared to just under 200 000 in September. The October level was the highest since March 1990. The October increase was broad-based across the country and suggests that the housing and related industries will remain positive factors for the Canadian economy through at least the fourth quarter of 2002.

Since the beginning of 2000, the Canadian dollar has depreciated against its U.S. counterpart. From about US69¢ in January 2000, the value of the Canadian dollar *vis-a-vis* the U.S. dollar has declined to about US63¢-64¢ in late 2002. For the year, the dollar should average about US63.5¢. Because Canada is a major exporter, the value of our dollar is strongly influenced by world commodity prices and by the economic performance of our major trading partners. Commodity prices (petroleum products excepted) have been low and the economies of the United States, and particularly Japan and the European Union, have lagged behind Canada's. The Canadian dollar is expected to strengthen through 2003 as the Canadian economy maintains its robust growth and as the U.S. recovery picks up steam. Given this scenario, by the end of 2003, the dollar could be trading near the US70¢ level. A downside risk to this forecast is the current uncertain global situation related to Iraq and periodic warnings of possible terrorist activities.

Exports are a significant part of Canada's economy. In 2001, exports contributed more than 40% to Canada's GDP. The export sector may, in the short term, be the one vulnerable spot in the Canadian economy, although the upward trend in exports since the beginning of 2002 is still intact. In September, exports rose by 0.8% (compared to August) to $35.1 billion due to increases in trade with the United States and the European Union. So far, Canada's exports have not been significantly affected by the U.S. economic situation, although the impact may be felt over the short term. For the first nine months of 2002, exports were down by 3.6% (to $306.6 billion) compared to the same period in 2001, with exports to the United States, Japan and the European Union all lower than the previous year's levels. With the anticipated strengthening of the U.S. economy (and a firming of commodity prices), the Canadian export sector should be able to weather any temporary slowdown that may occur. In addition, the relatively lower value of the Canadian dollar has given a significant lift to Canada's trade-oriented industries, especially the manufacturing sector. For these reasons, the value of merchandise exports is expected to strengthen further in 2003.

Merchandise imports declined in September to $30.3 billion, down 1.3% compared to August. Machinery and equipment, industrial goods and materials, and energy products were responsible for most of the decline. Imports of machinery and equipment, Canada's largest import sector, decreased 1.4% in September to $8.9 billion. For the first nine months of 2002, imports were down by 0.6% (to $265.2 billion), with declines from the United States more than offsetting increases from other countries.

Growth in the U.S. economy in 2002 should reach about 2.5% – not spectacular, but much improved over the tiny 0.3% rate realized in 2001. The economy grew at an annualized rate of 3.5% in the first half of 2002 and at a revised rate of 4.0% in the third quarter. Third-quarter growth was lead by personal consumption expenditures, government spending, equipment and software, private inventory investment and exports. Fourth-quarter growth is expected to slow. In response to this uneven recovery in the U.S. economy, the Federal Reserve Board in early November lowered its trend-setting Federal Funds rate by 50 basis points to 1.25%, the lowest level since 1961. Declining household spending over the course of the year, geopolitical uncertainty (particularly with respect to Iraq), concerns over corporate accounting scandals, and stalled business spending have combined to create the spotty recovery in evidence to date. The aggressive interest rate cut is expected to counteract these negative forces and lay the groundwork for a more robust recovery in 2003, when growth for the year should approach 2.7-3%, which is still relatively low for a post-downturn recovery.

Employment growth has not recovered from the 2001 downturn. The number of persons employed in the United States actually declined in each of the first two quarters of 2002 before becoming positive in the third quarter. For the year employment is expected to decline relative to 2001, but as the economy improves through 2003, employment may increase by about 1% for the year. The unemployment rate will likely remain just under 6% through 2003 as both employment numbers and the overall labour force should rise moderately. Excess capacity, low profit margins and uncertain capital markets have restrained business investment and have made business reluctant to hire new staff.

Housing construction in the United States fell sharply in October, down 11.4% from the 16-year high recorded in September. The decline indicates that while the housing market may have plateaued, interest rates at 40-year lows should continue to support the industry.

Price competition to maintain market share from both domestic and foreign firms has kept price increases subdued, with the CPI expected to average about 1.5% in 2002. Price pressures are likely to increase moderately in 2003, with the CPI rising by about 2-2.5% compared to 2002. These modest inflation figures should allow the Federal Reserve Board to maintain the current low interest rates into the middle of 2003. A modest series of rate increases through the second half of 2003 should bring the Fed Funds rate up to about 3% by year-end.

A major uncertainty over the next year or so will be the situation regarding Iraq and a possible conflict between Iraq and the United States or a United Nations-sanctioned force. In mid-November, the Iraqi government agreed to allow UN weapons inspectors into their country to search for “weapons of mass destruction” or to verify that no such weapons exist. This concession by the Iraqi government appears to have calmed the situation for the present, but the longer-term outlook remains volatile and the ultimate resolution is very much in doubt.

Citing the effect of a weak U.S. economy on Japan’s exports and industrial production, the Bank of Japan issued a gloomy assessment of the Japanese economy. The Japanese economy has stabilized, but hopes for a recovery are uncertain. Exports from Japan grew strongly in the first and second quarters of 2002, but have since weakened in line with lacklustre global demand. Domestically, the story is even more discouraging. Retail sales, including department store sales and new car sales, are declining and housing starts are at their lowest levels for many years. The consumer sector is suffering from high unemployment, very weak income and wage growth, and declining asset prices.

Japan’s gross domestic product rose 0.7% in the third quarter compared to the previous quarter after rising 1.0% in the April-June quarter. However, the Organization for Economic Co-operation and Development (OECD) reported that the Japanese economy, the world’s second largest, would probably shrink or show no growth for 2002 and that growth would remain stunted for the next couple of years.

In emerging markets in Asia,[2] activity has picked up markedly since the beginning of 2002, with industrial production and exports rebounding in response to the global upturn. The International Monetary Fund has projected growth for this area to be about 6% both in 2002 and 2003. However, the outlook remains dependent on external developments.

China will likely be the fastest growing economy in the region with growth topping 7% in both 2002 and 2003 and with a strong export sector boosting industrial production.

Aided by strong external demand and strong domestic demand in Russia and the Ukraine, growth in the Commonwealth of Independent States (C.I.S.) is expected to be a respectable 4.6% in 2002 and nearly 5% in 2003. These rates have moderated from 2001, however, due primarily to lower oil revenues and a return to more normal levels of agricultural growth, which was very high owing to the recovery from drought, and structural reforms to the Ukraine agriculture sector in 2000.

The European Union (EU) economy, apparently on the road to recovery earlier in 2002, seems to have faltered and is likely to lag the overall global recovery. Both business investment and consumer spending have weakened in the face of the pessimistic outlook. An interest rate cut may have provided some impetus to renewed growth, but the European Central Bank (ECB) in a meeting in early November 2002 elected to leave rates unchanged. Inflation is a concern in the Union where several countries are experiencing rapidly rising prices. Inflation has breached the 2% ceiling set by the ECB and money supply growth is above the ECB’s 4.5% upper limit. Consequently, the OECD has forecast growth to reach only 0.7% in 2002 and to rise to only about 2% in 2003.

Germany, the largest economy in the EU, has exhibited the slowest growth in the EU as its large export sector suffered as a result of weak global demand. Unemployment has also risen, prompting a cutback in consumer spending. Also, volatile foreign demand, weak equity markets and the uncertain geopolitical situation have caused the business sector to lose some confidence in the future. German growth is forecast to be a tiny 0.2% in 2002 and only 0.3% in 2003.

Economic and financial conditions in Latin America deteriorated in the first half of 2002 and remain fragile. Output contracted by 2.5% in the first quarter of 2002 (compared to the last quarter of 2001) and is expected to fall in 2002

[2] Includes developing Asia, newly industrialized Asian economies, and Mongolia.

as a whole. Financial indicators have come under particular pressure, reflecting both the broad-based sell-off in world equity markets and perceptions of increased political risk. Two countries in the region are faring better, however, and have largely resisted the region's difficulties – Chile, because of relatively low public debt, and Mexico, because of its close ties with the United States.

The financial crisis in Argentina (defaulting on its debt and devaluation of its currency) and its spillover effect on some other South American countries accounted for a significant portion of the output decline in 2002. Political uncertainties, high debt levels, large external financing requirements, and fragile banking systems in many of these regional economies are continuing to weigh on economic progress in the area. In order to reduce economic vulnerabilities, firm monetary policies, and structural reforms such as addressing banking sector weaknesses and liberalizing external trade policies, are required.

Improvements in global growth are expected to provide some support for the region next year, but downside risks related to the difficulties mentioned above still remain. Overall, the IMF expects the South American economy to grow by about 2.4% in 2003. Growth in the Mexican economy may reach 4%, although that rate could depend on the strength of the U.S. recovery.

The IMF has projected global growth to reach 2.8% in 2002 and to rise to 3.7% in 2003, underpinned by the turn in the inventory cycle and accommodative policies, with interest rate increases in the United States and the European Union likely deferred until well into 2003. Risks to the forecast are primarily to the downside. The global recovery depends heavily on the outlook for the United States, oil prices may spike if the unrest and uncertainty in the Middle East continues, equity markets remain very volatile, and risks in emerging markets in South America and Turkey have increased.

Note: Information in this article was current as of November 26, 2002.

Sources: Bank of Canada, *Monetary Policy Report, October 2002 Summary*; Canada Mortgage and Housing Corporation, Press Releases, October 8 and November 8, 2002; International Monetary Fund, *World Economic Outlook*, September 2002; RBC Financial Group, *Economic and Financial Market Outlook*, Autumn 2002; Scotiabank Group*, Global Outlook,* September 2002, and *Market Trends*, November 1, 2002; Statistics Canada, *Canadian Economic Observer*, October 2002; *The Daily*, October 18, 2002, November 8, 2002, November 19, 2002, November 21, 2002; TD Economics, *Global Economic Outlook*, July 21, 2002, *Quarterly Economic Forecast*, September 16, 2002; TD Economics Commentary, October 16, October 18, October 23, October 31, November 6, November 19 (2) and November 21, 2002; TD Economics, *The Bottom Line*, November 8, 2002; TD Economics Topic Paper, November 7, 2002; Comments and reports on aspects of the Canadian and world economic situation and outlook in *The Globe and Mail Report on Business* and *The Financial Post.*

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