Canadian and World Economic Situation and Outlook

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In the third quarter of 2005, the Canadian economy (real Gross Domestic Product) grew by an annualized 3.6%, following increases of 3.4% in the second quarter and 2.0% in the first quarter. The third-quarter growth rate is the highest since the second quarter of 2004. The third-quarter increase brings Canada's real GDP (annual rate in chained 1997 dollars) to $1 162 865 million ($1 385 940 million nominal dollars), compared to $1 124 428 million in 2004 ($1 290 185 million nominal). Overall, real growth in 2005 should come in at about 2.8% and accelerate slightly to about 2.9% in 2006 as a possible slowdown in domestic demand will likely be offset by improved global market prospects.

Factors that influenced the Canadian economy in 2005 include continuing high commodity prices, high energy prices, low but rising interest rates, a strong Canadian dollar, strong demand for Canadian exports, especially to China and the United States, record employment levels, and high personal incomes and corporate profits.

Another factor of note is that Canada was the only Group of Seven (G7) country to report a total government surplus in 2004 and is projected to be the only G7 country to be in a surplus situation again in 2005 and 2006.

The U.S. economy grew at a 4.3% annualized rate in the third quarter of 2005, compared to a 3.8% real growth rate in the first quarter and a 3.3% increase in the second quarter. Components that contributed to the third-quarter increase were: increased consumer spending on goods and services, increased business investment in equipment and software, increased federal government spending, and increased residential fixed investment spending. Inventories were being drawn down, but at a slower pace than in the previous quarter. These positive contributors to third-quarter growth were partially offset by a slowdown in exports. Following a real growth rate of 4.2% in 2004, growth in 2005 is expected to slow somewhat to 3.6-3.7% and to about 3.5% in 2006 as rising interest rates and record consumer debt loads begin to affect consumer demand.

As in 2004, the strength of the Canadian dollar in 2005 and how the Canadian economy has responded to it is the big story. Indeed, the Bank of Canada, in its *Autumn 2005 Review*, devoted the entire issue to exchange rates and the Canadian economy. As of this writing, the Canadian dollar is trading above US$0.85, a level not seen since early 1992. This strength appears to be underpinned by fundamental factors, including high prices for crude oil, natural gas, and other commodities such as copper. Also influencing the dollar's strength is Canada's generally solid economic performance. The Canadian dollar is expected to remain at about the US$0.85 level through 2006.

Although exchange rates can influence many facets of the economy, they are felt most directly through international trade. The current appreciation of the Canadian dollar began in early 2003. While there are other factors that affect trade levels, it is worth noting that, following the first quarter of 2003, the value of exports of goods declined from $106.3 billion to under $100 billion for each of the remaining quarters of 2003. Since then, the export sector has adjusted well to the dollar's strength, helped in large measure by high energy values. In fact, record energy export values in the third quarter of 2005 lifted the total value of exports of goods in that quarter to a record $116.2 billion, surpassing the previous record of $112.5 billion reached in the fourth quarter of 2000. In addition to the energy sector, the automotive sector saw sales to the United States increase as a result of buyer incentives. Also faring well were the resource sector and the agricultural and fish sectors. The forestry sector continued to lag though, as exports declined for the fifth consecutive quarter. The forest industry suffers from a number of difficulties. Higher energy costs have increased manufacturing and transportation costs. The rise in the Canadian dollar has reduced profits as forestry products are sold in U.S. dollars (as are many other products). Punitive duties from the United States have also hurt. These factors are compounded by weak pulp and paper prices, declining demand for photocopy paper, and overcapacity.

Already strong in North America and most of Asia, global economic momentum also appears to be benefiting from the Japanese and European recoveries. With this background, Canada's export sector may be expected to continue to expand by over 5% in 2006.

Although the higher value of the Canadian dollar has a dampening effect on import prices, imports of goods increased $1.1 billion in the third quarter to reach a record level ($97.4 billion) for the third consecutive quarter. Like exports, the value of imports of energy products increased because of higher prices. Automotive product imports, particularly vehicle parts, also increased in the third quarter. Canada's relatively stronger dollar makes U.S.-made machinery and equipment less expensive.

The trade surplus reached $18.8 billion in the third quarter of 2005, the fourth highest value on record and the highest since the second quarter of 2004.

China is becoming an increasingly important trading partner with Canada. In 2004, China was Canada's fourth leading country of destination. Exports to that country totaled $1.4 billion and China was the second leading importer to Canada with goods totaling $3.3 billion.

Rising energy sector and metal commodity prices have had a significant positive impact on corporate profits, especially for the mining and mineral fuel industries. Corporate profits in the third quarter of 2005 increased by 5.4%, stronger than the second quarter's 3.3%. As interest rates rise and commodity prices decline from their present lofty levels, corporate profit growth may be expected to slow somewhat in 2006. Corporate profits have contributed an increasing share to total GDP, rising from 11% in 2002 to 14% in the third quarter of 2005.

Strong corporate profits and relatively low dividend payouts have allowed corporations to build up substantial cash reserves, which in turn may be used for further investment in machinery and equipment. Business investment may be expected to increase in 2006 by more than 7%, compared with an estimated 10% in 2005.

In an effort to stem inflation, the Bank of Canada began raising its key overnight interest rate in September 2005, the first increase in the rate since October 2004. A 25-basis-point increase in September was followed by further 25-point increases in both October and December, bringing the rate to 3.25%. Further increases are expected until the rate reaches at least 4% in the middle of 2006.

The All-Items Consumer Price Index (CPI) spiked in September 2005, increasing 3.4% compared to a year earlier. This hefty increase was primarily the result of energy price increases resulting from shortages caused by Hurricane Katrina. Energy prices declined quickly (but were still at high levels) as supplies came back on stream, resulting in a reduced increase in the CPI in October of 2.6%. The Bank is concerned about inflationary pressures for several reasons, although its interest rate policies are designed to counteract these pressures and keep inflation under control. Energy prices are much higher and, while they may decline somewhat, will likely remain high. Meanwhile, home prices and property taxes are both up. Canada's low unemployment rate has begun to accelerate wage gains, while tight capacity utilization rates may lead to price increases by manufacturers (although with global competition, these increases may be limited). Also, higher fuel and other energy costs may filter through into higher prices for other goods.

The core inflation rate, which excludes eight volatile components (including fuel), reached 1.7% in October. Although this is below the 2% Bank target, it will be closely monitored.

Overall for 2005, the All-Items CPI will likely reach about 2.2%, above the 2004 level of 1.8%, but well within the Bank's target range of 1-3%. Given the Bank's policy thrust, inflation should remain under control, possibly increasing by a little less than 2% in 2006.

Consumer spending slowed in the third quarter of 2005. Spending increased by 0.6% in the third quarter compared to 0.8% in the second and 1.6% in the first. Increased expenditures for electricity and new motor vehicles were offset by declines in purchases of clothing and household furnishings, the latter at least partially caused by a decline in new housing construction. Personal disposable income accelerated to 1.6% in the third quarter compared to 1.3% in the previous quarter and 4.2% above year-ago levels. Given Canada's tight labour force, healthy income growth may be expected for a while yet. Even so, rising interest rates and high debt levels may begin to slow the increase in consumer expenditures, especially for durable goods. Consumer expenditure increases for 2005 should approach 4% and slow to less than 3% in 2006.

The third-quarter personal savings rate remained below 0% for the third successive quarter, but improved from -0.6% in the second quarter to -0.2% in the third. Given the combination of higher interest rates, increased disposable income and a likely reduction in the pace of consumer spending, the savings rate may be expected to once again reach positive territory.

After several months of moderate growth, employment jumped by 69 000 in October and a further 31 000 in November, bringing total gains over the last 12 months to 250 000, mostly in full-time employment. The unemployment rate, which was below 7% in each month of 2005 except January and February, declined to 6.4% in November, its lowest level in over three decades. While job growth should remain fairly robust, the tight employment situation leaves little room for further strong gains. The unemployment rate for 2006 will likely average about 7%, slightly higher than the 2005 average of about 6.8%.

The U.S. economy showed surprising strength in the third quarter of 2005, with the GDP (annual rate in chained 2000 dollars) reaching US$11 206.1 billion (US$12 601.0 billion nominal dollars), 3.7% above the same quarter in 2004. Growth in the U.S. economy should approach a respectable 3.6% in 2005, although less than the 4.2% growth rate registered in 2004. The acceleration of GDP growth in the third quarter (a 4.3% annualized increase compared to 3.3% in the second quarter) primarily reflected a smaller decrease in private inventory investment and an acceleration in personal consumption expenditures and federal government spending. Consumer spending, which represents about 70% of economic activity, grew by 4.2% during the quarter. These positive factors were partially offset by a deceleration in exports, an upturn in imports, and a deceleration in state and local spending. Also, corporate profits fell 3.4% in the third quarter compared to a 4.6% increase during the second quarter. Much of that decline is linked to insurance payouts related to Katrina. The impact of Hurricane Katrina will likely be negative for fourth-quarter growth, but then positive in the first half of 2006 as clean-up and rebuilding efforts take hold.

The pace of consumer expenditure increases is likely to slow in 2006. Over the last couple of years, a large portion of consumer spending was the result of a rapid appreciation of real estate assets, allowing consumers to access this through home equity lines of credit. Higher interest rates, record debt loads and a slowing of house price appreciation will likely reduce consumer expenditure increases to an average of about 3% in 2006, with the effect most pronounced during the second half of 2006.

The U.S. Consumer Price Index increased 0.2% in October 2005 from the month earlier, lower than the energy-related 1.2% spike registered in September, bringing the year-over-year increase in the CPI to 4.3%. While core inflation, with energy and food removed from the Index, also increased by 0.2% in October, the annual change remained at about 2%, a rate that has been maintained for several months, thus indicating that energy prices have not yet passed through to other prices. The Federal Reserve's monetary tightening policy is designed to curb inflationary pressures and has been successful so far. Since the middle of 2004, the Federal Reserve has raised the key federal funds rate 12 times from 1% to the current 4%. Recent data regarding GDP growth, employment levels, wage gains, and production capacity suggest that the Federal Reserve will continue raising rates until the middle of 2006 to at least 4.5%.

Non-farm payroll employment grew by 215 000 in November, bringing growth for the first 11 months of 2005 to 1.84 million. Job growth was widespread, with substantial gains made in the construction and service industries. Even the manufacturing sector gained 11 000 jobs in November, compared to a six-month average loss of 5200 jobs. The year-over-year increase in average hourly earnings reached 3.2% compared to 3% in October, and the unemployment rate remained at 5%. The jobless rate has fluctuated very narrowly from 4.9% to 5.1% since May 2005. As the U.S. economy is expected to slow somewhat during the latter part of 2006, the unemployment rate may be expected to rise to about 5.4% towards year-end and to average a little over 5% for 2006.

Widening U.S. budget deficits and the U.S. current account deficit are two concerns with respect to the U.S. economy that were highlighted, most recently by Alan Greenspan, outgoing Chairman of the Federal Reserve. While both are risks to future U.S. growth, Mr. Greenspan believes the budget deficit is the more serious concern. Rising retirement and medical costs pose threats to future economic prospects. The deficit did narrow by US$94 billion in the fiscal year ended September 30 to US$318.6 billion after tax cuts and spending increases pushed the deficit to 3.5% of GDP, or a record US$412.8 billion a year earlier. But economists at Goldman Sachs & Co. and Lehman Brothers Inc. believe rising federal spending and slower tax receipts will push the deficit up to US$425 billion in the current fiscal year. Mr. Greenspan suggests that spending cuts and not tax increases are the best approach to lowering the deficit.

The current account deficit is less of a problem as the U.S. interest rate policy and strong economic growth make investment in U.S. assets attractive to foreign investors, enabling the U.S. to finance its deficit relatively easily.

Economic growth in China and the United States are both major contributor to the global economy. Over the first half of 2005, real GDP growth in China advanced 9.5%, the same rate as in both 2003 and 2004. Exports continue to be a big part of this, although increased consumer spending is beginning to contribute a larger share. This pace of growth is likely to slow only modestly over the next couple of years, but risks associated with the Chinese real estate market (measures have been introduced to curb mortgage lending) and the banking sector's huge portfolio of bad loans may precipitate a more rapid slowdown.

At a meeting of the Group of Seven (G-7) industrial nations in early December 2005, officials urged the Chinese government to make its currency more flexible. China's yuan had been pegged to the U.S. dollar until July 2005 when it was pegged to a basket of currencies. This allowed its exchange rate to increase in value by 2.1%. G-7 officials argued that this was insufficient and that more was needed to help cut the U.S. trade gap and aid economic growth in Europe and Japan. The Chinese finance minister made no commitments regarding further currency flexibility.

In Japan, real GDP is likely to reach at least 2% in 2005, the second straight year of 2% or higher growth, and to continue at about that rate in 2006. High levels of energy efficiency in Japan allowed it to weather the energy price shock relatively well. The re-election of the Japanese prime minister in 2005 has given him a strong mandate to pursue much-needed structural reforms. Mounting public spending pressures associated with an ageing population may require fiscal tightening, although monetary policy is expected to remain relatively moderate in order to combat deflation. The CPI is expected to decline by 0.2% in 2005 and to barely get into positive territory in 2006.

Growth in India remained robust in 2005 with the continued expansion in services, including information technology, and accelerating industrial production. For 2005, output will likely expand by about 7%, then cool in 2006 to around 6.5%.

Growth in other emerging Asian economies is expected to become more dependent on Chinese demand as high energy prices and the prospect of slower U.S. growth will likely cut into their growth rates. In the ASEAN-4 (Indonesia, Thailand, the Philippines and Malaysia), the high cost of energy is putting upward pressure on inflation and affecting consumer spending. ASEAN growth rates are expected to decline to about 4.8% in 2005 from 5.8% in 2004, before rebounding to over 5% again in 2006. For Asia generally, excluding Japan, growth is expected to moderate to just less than 7% in 2005 (from 7.9% in 2004) and to about 6.7% in 2006, depending, of course, on China's economic performance.

The European Central Bank (ECB), in a move designed to keep inflation in check, raised its key interest rate in early December 2005 by a quarter of a percent to 2.25%. The rate had remained at 2% since June 2003. The Bank stated, however, that the increase was not the first in a series, but that rates will remain accommodative. Inflation in the EU rose to 2.6% in September 2005, compared to 2.2% the previous September, on the heels of higher energy prices. The ECB inflation guideline is just below 2%. Some economists and government officials questioned the rate hike, however, believing that growth in the European economy is still fragile and that the inflation is driven by energy costs, not domestic demand. With domestic demand stagnant, the EU remains too reliant on exports. Consumer spending in Germany, Europe's largest economy, fell for the third quarter in a row.

The ECB expects inflation of about 2.1% in 2006. It also projects growth to accelerate to 1.9% in 2006 compared to 1.4% in 2005.

According to the International Monetary Fund (IMF), the Latin American region continues to benefit from strong commodity prices and is projected to grow 4% and 3.75% in 2005 and 2006, respectively. There are downside risks though. Key among the external risks is the possibility of a sharper-than-expected slowdown of growth in key trading partners or international trade, possibly triggered by a continued surge in oil prices and/or rising protectionist sentiment. The region also remains vulnerable to an abrupt tightening of global financial market conditions as debt ratios still remain high in many countries and there remains a high dependence on exchange-rate-linked and short-term instruments. However, strong export growth and improved macro-economic policies should help sustain the region's expansion.

Global growth appears to have slowed somewhat in 2005 to 4.3% from 5.1% in 2004. World output is expected to increase a further 4.3% in 2006. Global expansion has continued to be led by the United States and China, growth projections in most other regions being marked downward. Monetary policy stances are becoming more differentiated with countries such as Canada and the United States raising rates, Japan keeping rates on hold, and the Bank of England reducing rates. Partly as a result of this, movements in currencies have varied widely with, for example, the Canadian dollar appreciating and the yen and euro depreciating.

Global current account imbalances remain. The U.S. deficit is the most notable. Notable on the surplus side are Japan, China, Middle East oil exporters, and the Commonwealth of Independent States.

Global inflation has picked up slightly due to higher oil prices, but remains at moderate levels. Among the major industrial nations, core inflation appears generally contained, although rising unit labour costs, especially in the United States, need to be watched. Inflationary pressures have risen somewhat more in emerging markets – there could be a danger of overheating economies in some countries with large external surpluses.

Sources: Bank of Canada; Bloomberg; Finance Canada; International Monetary Fund; Organization for Economic Cooperation and Development; Statistics Canada; TD Economics; United States Bureau of Economic Analysis; United States Bureau of Labor Statistics; and 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.*

Note: Information in this article was current as of early December 2005.

Note to Readers