The Canadian and World Economic Situation and Outlook

Greig Birchfield
Minerals and Mining Statistics Division
Telephone: (613) 995-2277
E-mail: gbirchfi@nrcan.gc.ca

The Canadian economy, benefitting from low interest rates and low and stable inflation, is now growing very strongly, and the economic environment is the most positive it has been for the last 25 years. Government fiscal policies aimed at reducing deficits, and debt and monetary policies aimed at keeping inflation under control, have contributed to this environment and provide a sound basis for continued strong growth.

Inflation in Canada, as measured by the change in the Consumer Price Index (CPI), averaged 1.8% for the first ten months of 1997. This rate is well within the range of the Bank of Canada's inflation target of 1% to 3%, and shows no signs of increasing significantly. Even so, with the pace of economic growth showing no signs of abating, the Governor of the Bank of Canada has reiterated the need for a modest, gradual tightening in monetary conditions from the current, still accommodative stance. The inflation rate is expected to rise only slightly to about 2% in 1998 from an average of about 1.8% in 1997.

Since the recent high in the bank rate of 8.5% in early 1995, the Bank of Canada has steadily reduced interest rates, taking the rate to 3.25% in November 1996, a figure not seen since the mid-1950s. The rate was nudged up by 0.25% in June 1997 and by a further quarter percent in October 1997. In contrast to the June increase – which was designed to "rebalance" overall market conditions in reaction to a steep slide in the value of the Canadian dollar – the Bank's latest move was geared towards a gradual firming of monetary policy. Further hikes are possible, with Bank officials pointing to the need for a move to more neutral settings aimed at preventing an eventual build-up of inflationary pressures and increasing the value of the Canadian dollar. After averaging about 3.2% in 1997, economists are forecasting short-term rates (90-day T-Bills) to rise to average about 3.8% in 1998.

As a consequence of the low inflation and low interest environment, domestic consumer spending has gathered strength since mid-1996. This is being reflected in brisk sales of houses, automobiles and other consumer goods. Housing starts, which rose from 111 000 units in 1995 to 125 000 in 1996, are expected to reach 150 000 in 1997 and to remain at that level through at least 1999. This higher level of housing activity will contribute to increased demand for furniture and appliances.

As well, strong domestic sales and corporate profitability are supporting a surge in business investment. Business capital spending, especially for machinery and equipment (M&E), continues to be a major source of economic growth in Canada, rising, in real terms, at double-digit rates. With the prospects of a favourable business climate in Canada continuing, real investment in M&E is expected to continue at a healthy clip. Non-residential construction should also pick up steam as an uptrend in industrial capacity utilization spurs industrial construction and as falling office vacancy rates encourage commercial construction.

While exports have remained buoyant in 1997, reaching a record $25.2 billion in August, imports have risen even more, also reaching a record $23.8 billion in August. As a result, the trade balance has deteriorated. A combination of business purchases of foreign machinery, equipment and industrial goods, and consumer purchases of goods, has led to the surge in imports. The vibrant import sector is another reflection of the strength of the domestic recovery.

Although domestic economic strength will continue to support the demand for foreign goods and services, the pace of import growth is expected to slow. At the same time, export growth will remain robust, reinforced by continued U.S. expansion. This should lead to a gradual improvement in Canada's current account surplus. One concern for the export sector is the economic situation in Japan and Southeast Asia where weak markets and sinking currencies are hindering Canada's exports (especially exports of raw materials such as lumber and aluminum).

Strong economic growth is creating employment opportunities for Canadians. Job creation has continued to strengthen since the end of 1996. For the first nine months of this year, 293 000 jobs were created, all in the private sector and most of them full-time positions. For the year as a whole, job growth of nearly 400 000 is within sight. In spite of this

healthy job growth, the unemployment rate, while declining, is still relatively high due to an influx of workers re-entering the labour force. From a recent high of 10.3% in November 1996, the unemployment rate has declined to the present rate of about 9%. For 1997, the unemployment rate should average about 9.2%. Modest but steady declines in the unemployment rate should continue, with rates of about 8.6% expected for 1998.

With the possible exception of the United States, the economic performance of the Canadian economy is expected to lead that of all G-7 countries this year and next, propelled by healthy gains in domestic demand. Steady job creation will boost disposable incomes and fuel consumer spending, while low interest rates will support housing activity and business investment. For 1997, real growth in the Gross Domestic Product (GDP) should rise by about 3.6%. Growth is expected to slow slightly to about 3.5% in 1998 and to about 2.8% in 1999 as slightly more restrictive monetary policies begin to have their effect.

Already in the seventh year of its expansion, the U.S. economy has continued to combine solid growth of output and employment with low inflation and a diminishing fiscal imbalance. Although growth slowed somewhat during the second quarter of 1997, recent data on industrial output and housing starts suggest that rapid economic growth has resumed and may continue through 1998. This strong growth is likely to rekindle inflationary pressures early in 1998, resulting in an increase from an average of about 2.5% in 1997 to about 3% by the end of 1998. This modest rise is despite wage gains running at about 4% year-over-year and the unemployment rate hovering at around 5%. The tame inflation to date reflects a number of factors: the appreciation of the U.S. dollar since early 1995, rising labour productivity, and efforts by corporations to control costs. Looking forward, however, the current tightness in labour markets may lead to rising unit labour costs that will, in turn, translate into higher consumer prices. The U.S. Federal Reserve Board will continue to carefully monitor price movements and will likely raise rates, especially if inflation picks up before the rate of GDP growth slows appreciably. But rates are not expected to be increased aggressively or frequently.

The financial crisis in Southeast Asia (most notably in Thailand, the Philippines, Indonesia, Malaysia and Hong Kong) will probably curb U.S. economic growth in 1998 and 1999. An estimate by the Chase Manhattan Bank shows that the U.S. economy may be retarded by about 0.5% in 1998 and 1999. The crisis will likely slow the economy through three channels: exchange rates, wealth, and supply. The depreciation of several currencies has made U.S. goods more expensive in those countries. The plunge in the value of Asian stocks has reduced financial wealth in that region. The spillover to North American stock markets tends to shake consumer confidence and thereby slow demand for U.S. products both domestically and on foreign markets. An economic slowdown in Asia will probably boost excess global capacity while increasing competitiveness. This may ultimately put downward pressure on prices, keeping inflation low. In this environment, it will be more difficult to justify a change in the course of U.S. monetary policy, and it will reinforce the idea that the economy can slow on its own without undo inflation.

In Japan, the recovery strengthened in late 1996 and early 1997 due to a pickup in domestic demand. Exports also began to recover in response to a weaker yen. Economic activity, however, fell sharply in the second quarter of 1997. A sharp fall in consumer spending, prompted by an April rise in the consumption tax and a June repeal of an income tax rebate, led the contraction. The combination of strong export demand and an increase in business investment should contribute to expansion in the latter half of 1997, but overall for 1997, growth will probably only be about 1%. A large amount of spare capacity will ensure that inflation remains low, although it will jump in 1997 as a result of the 2% April retail sales tax increase. Although employment will rise, greater participation in the labour force will prevent the unemployment rate from falling much from its current relatively high rate of over 3%. In 1998, with a slower pace of fiscal consolidation, and propelled by rising external and domestic demand, growth is expected to accelerate to 2.0-2.5%. Even higher rates are forecast for 1999. Given the absence of underlying inflationary pressures and uncertainties regarding recent tax hikes, official interest rates are not expected to rise until the recovery is firmly established. As the recovery proceeds, and in light of a widening of Japan's international current account surplus, the Japanese yen is expected to strengthen in 1998/99. As with other countries, the economic crisis engulfing Southeast Asia constitutes a continuing downside risk.

The British rate of economic expansion has permitted steady falls in the unemployment rate and has sparked wage gains and increased consumer spending. Exports remain weak due to the strength of the sterling. Real GDP growth is expected to reach 3.5% in 1997, and then to moderate to about 2.6% in 1998.

In Germany and France, growth is picking up after disappointing performances in 1995 and 1996. Exports are providing much of the strength, with domestic demand remaining relatively weak as a result of high unemployment and fiscal restraint. Given the tentative nature of the recovery, monetary policy is expected to remain unchanged for at least the remainder of 1997. Growth rates for these countries are expected to be a little over 2% in 1997 and closer to 3% in 1998.

In the spring of 1998, the member countries of the European Union (EU) will decide on the initial group of participants in the planned European Monetary Union (EMU). The scheduled launch date is

January 1, 1999, with the initial participation of at least Germany, France and the Benelux countries. However, considerable volatility in European financial markets can be expected in advance of the launch.

Growth in Australia and New Zealand moderated during 1996 due in part to monetary tightening; as inflation risks have abated, monetary conditions have eased and growth is expected to accelerate in the period ahead.

Real GDP growth in the developing countries is expected to remain relatively buoyant at slightly over 6% in 1997 and again in 1998. While the rapid expansion of the Asian region is projected to moderate, many countries that saw a marked strengthening of activity in 1996 are expected to sustain this improvement in the period ahead.

Several countries in Southeast Asia have experienced financial market pressures linked to concerns about large external deficits; currencies linked to the appreciating U.S. dollar have aggravated the tensions. The pressures were felt first and most acutely in Thailand where fragilities in the banking system contributed to market concerns. Spillovers from the crisis were felt by other countries in the region, especially the Philippines, Indonesia, Malaysia and Hong Kong. Growth in these countries is likely to slow significantly in the short run but should return to its quite strong longer-term trends.

According to the International Monetary Fund (IMF), the global economy is expected to expand by some 4.0-4.5% in both 1997 and 1998, the strongest pace in a decade. Although moderation of world growth is likely to occur at some point, there are reasons to believe that the current expansion can continue into the next century: global inflation remains subdued, fiscal imbalances are being reduced, and exchange rates are generally within ranges consistent with fundamentals. World growth is providing both new markets and increased production capacities; these developments are stimulating trade and growth worldwide while helping to dampen prices. Cyclical divergences have remained sizable among the advanced economies, and there are still considerable margins of slack in Japan and continental Europe. Stronger growth in the period ahead in those countries should support global activity as growth slows to more sustainable levels in those countries that have already reached more mature stages of expansion. In view of the above, the IMF's medium-term scenario points to a trend growth rate in world GDP of about 4.5% between 1996 and 2002, always keeping in mind there is a wide range of risks that may confront individual countries and affect regional and world economic and financial conditions.

Note: Information in this article was current as of November 20, 1997.