The Canadian and World Economic Situation and Outlook

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The Canadian economy continues to grow at a very healthy pace. Real Gross Domestic Product (GDP) rose by 4.5% in 1999 and, for the year ending the second quarter of 2000, the pace of expansion accelerated to 5.3%. The economic growth is well balanced with business investment, consumer spending and merchandise trade all contributing. In spite of this very strong growth, inflation remains under control. Growth in Canada is expected to slow through the last part of this year and in 2001, reflecting the tightening monetary policy of the last year, a slowing U.S. economy, higher energy costs and high consumer debt. For 2000, real GDP is expected to expand by about 4.7% and then slow to a little over 3% in 2001, a rate that can be maintained without fuelling inflation. The core rate of inflation in 2001, excluding the food and energy components, is expected to rise slightly to the upper region of the Bank of Canada's target range of 1-3%.

Canada's inflation rate has been low for several years, averaging 1.4% from 1997 through 1999. For the first 10 months of 2000, the Consumer Price Index (CPI) has increased moderately to average about 2.6%. The core rate, however, has remained remarkably steady, averaging 1.5% so far in 2000, the same as the average for the previous three years. For 2000, the all items CPI should average about 2.7% and remain at about that level in 2001.

The bank rate, as set by the Bank of Canada, stood at 4.75% in October 1999. Successive 25-to-50-point increases since then moved the rate to 6% by May 2000, the level at which it remains as of November 2000. These increases closely followed those in the United States as Canada and the U.S. attempted (so far successfully) to slow the economies of both nations to levels sustainable without causing an outbreak of inflation. Evidence now indicates that the North American economies are slowing. While remaining vigilant and maintaining a slight tightening bias, the Bank of Canada and the U.S. Federal Reserve are not expected to raise rates over the short term. By late 2001, rates may even begin to decrease modestly.

In spite of Canada's current account surplus, low inflation and improved fiscal situation, the Canadian dollar has depreciated against the U.S. dollar. The Canadian dollar began the year at US$0.69 but, by mid-November, hovered around US$0.65. This is a reflection of the strength of the U.S. currency rather than a weakness in the Canadian currency. The Canadian dollar has given up the least ground against the U.S. currency of any of the major world currencies. In light of strong Canadian economic fundamentals, many believe the Canadian dollar is due for at least a modest recovery against the U.S. dollar and continuing strength against other currencies.

Even though consumer debt levels are at record highs (including mortgage debt, the level is about 100% of personal disposable income), debt service costs are relatively low, thus, consumer spending is expected to rise by about 3.7% in 2000 before moderating to about 3% in 2001 as spending on interest-sensitive durable goods declines. Employment growth of about 2.5% in 2001, real personal disposable income growth of perhaps 3%, and continuing tax relief from the federal and provincial governments should sustain consumer spending levels. Canada Mortgage and Housing Corporation predicts housing starts will reach nearly 155 000 units in 2000 and rise to nearly 161 000 in 2001. This compares to 149 968 in 1999. In October, housing starts rose to an annual rate of 164 800 from 157 100 in September. However, there is evidence that housing starts may be peaking as higher interest rates, energy costs and softer equity prices begin to affect the housing market.

Low financing costs have contributed significantly to Canadian business investment in machinery and equipment, especially high-technology equipment such as computers. Investment grew by 15.6% in 1999 and is expected to reach nearly 20% in 2000. This pace will not likely be sustained in 2001, but rising corporate profits, high capacity utilization rates, low borrowing costs, and the adoption of new technologies are all factors that should maintain healthy business investment expenditures. To the extent that investment in high-technology equipment or information technology supports productivity growth, business investment can be expected to improve

Canada's productivity performance and, hence, to subdue inflationary pressures.

While both the level of exports and imports increased in August (the latest month for which data are available), the merchandise trade surplus reached $4 billion. There is little evidence that a slowdown in the U.S. economy is affecting the merchandise trade sector, although a decline in U.S. housing starts hampered the forestry sector. The main contributor to the rising export values was higher export volumes, although higher energy prices also contributed. Based on information available through August, a trade surplus of about $38 billion may be expected in 2000. This should contribute to a current account balance of more than $14 billion in 2000, compared with a negative $3.8 billion balance in 1999.

Full-time jobs in Canada increased by 51 700 in October, bringing the total number of full-time jobs created for the first 10 months of 2000 to 261 000. The number of part-time employees declined by 30 500, for a net increase in the number of jobs of 20 200. In spite of the healthy increase in the number of jobs in October, the unemployment rate rose to 6.9% from 6.8% in September as the number of people in the labour force increased by 34 800. Canada's unemployment rate has declined steadily over the last few years, from 9.1% in 1997 to 7.6% in 1999, to an average of 6.8% for the first 10 months of 2000. Job growth over the next year is expected to be moderate but, with further gains in labour force participation anticipated, the unemployment rate will likely decline only modestly to about 6.5%.

The expected slowdown in the U.S. economy appears to have begun. Following a 4.2% rate of real GDP growth in 1999, the U.S. economy surged ahead in the first half of 2000 at a 5% pace (5.6% in the second quarter). Preliminary third-quarter results released by the U.S. Department of Commerce show that the economy grew by only a 2.7% annual rate, less than half the rate of the previous quarter. This growth slowdown was much swifter than many forecasters had predicted and seems to indicate that the Federal Reserve's interest rate policy has obtained the desired result of slowing the U.S. economy to a sustainable non-inflationary pace. Between June 1999 and May 2000, the Federal Reserve raised its benchmark funds rate from 4.75% to 6.5%. Other factors influencing the reduced growth rate are high energy prices, softer equity markets and a firm U.S. dollar. There are factors at work in the latter part of 2000 that may cause the economy to slow even more, including another potential jump in oil prices, disappointing corporate profit news, and slumping stock market performance. For 2000 as a whole, real growth should approach 5%, with growth slowing in 2001 to about 3% as the interest rate hikes and a firm U.S. dollar continue to exert their influence.

Inflation in the United States has increased slightly over the last year from an average of 2.2% in 1999 to an expected level of just over 3% in 2000. Moderating consumer expenditures in 2001 and robust business investment should help contain inflationary pressures. Corporate profits are likely to moderate from 2000 to 2001 as rising input costs combined with a competitive pricing environment and a strong U.S. dollar have their effect. This may temper their hiring somewhat, easing the very tight labour market. In October, the rate stood at 3.9%, the same as in September. For 2000, the unemployment rate is expected to average about 4% and, for 2001, to rise slightly to about 4.2%.

As a result of strong domestic demand and a negative merchandise trade balance, the U.S. current account deficit has been widening, reaching an annualized $420 billion in the second quarter of 2000, a record 4.3% of GDP. To run a current account deficit, foreign capital must be invested in the United States. The increased demand for U.S.-denominated assets has resulted in an appreciation of the U.S. dollar in relation to most of the world's major currencies. To the extent that the form of these investments are in equities, any indication that these equity values may be leveling off may prompt a change in investor sentiment out of the United States, resulting in a depreciation of the currency and a potential source of inflationary pressure.

Most regions of the world are enjoying stronger growth than last year, with 2000 shaping up to be the best year in a decade, as growth is likely to reach 4.5%, compared with only 2.5% in 1998, the period of the emerging markets' financial crisis. As 2000 is likely to mark the peak of the current recovery cycle, world economic growth is expected to moderate in 2001 to between 3.5% and 4%.

The North American economies should remain atop the G-7 rankings in 2000, but the euro-zone has rebounded strongly, bringing with it robust employment growth. Although the euro currency continues to decline relative to the U.S. currency, the major euro-zone economies of Germany, France and Italy are expected to turn in their strongest economic rate of growth in nearly a decade in 2000. The European Central Bank is expected to further increase interest rates in an attempt to bolster the euro and to also curtail possible inflationary pressures due to rising energy prices and depreciating currency. Reduced corporate and personal income tax rates in 2001 should support economic growth.

The Japanese economy registered two consecutive quarters of growth in the first half of 2000, indicating that perhaps the economy has bottomed out. While industrial production and business investment have risen this year, ongoing corporate, financial and public sector restructuring will continue to weigh on

Japanese growth prospects. Recent unemployment rates of about 4.9% are near historic highs. Confidence has been shaken by a number of corporate bankruptcies and the precarious state of the government's finances, with the budget deficit approaching 10% of GDP. Given these factors, economic growth in Japan is unlikely to reach 2% this year or in 2001.

There are several positive developments in the emerging markets. China's economy expanded by more than 8% in the first half of 2000. Economic growth has also been impressive in the information technology economies of Malaysia, Singapore, South Korea and Taiwan. In Indonesia, political uncertainty impedes the implementation of needed economic and financial reforms. Overall, economic growth in Asia, excluding Japan, is expected to reach 6.6% in 2000 and then to moderate somewhat to 6.2% in 2001.

Many emerging market oil producers, especially the OPEC countries, Mexico and Russia, have seen their fiscal and current account positions enhanced significantly. Mexico has also benefited (along with Brazil) from the strong North American economies. Mexico's growth rate is likely to reach 5.5% in 2000 then decline to 4.4% in 2001. Latin America in general should see growth rates of over 4% in both 2000 and 2001.

Note: Information in this article was current as of November 10, 2000.

Sources: Toronto Dominion Bank, *Quarterly Economic Outlook*, September 2000; *Royal Bank Economic Outlook*, Autumn 2000; Toronto Dominion Bank, *Comment on August Merchandise Trade*; Statistics Canada, *Canadian Economic Observer*, October 2000; Newspaper articles on aspects of the Canadian and world economic situation and outlook.