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The Canadian and World Economic Situation and Outlook

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In the third quarter of 2004, the Canadian economy (real gross domestic product) grew by 3.2% annualized, following increases of 3.9% in the second quarter and 2.7% in the first quarter. The third-quarter increase, while still relatively strong, was less than generally expected. (By way of comparison, the economy grew by 2.0% in 2003 and 3.4% in 2002.) The economy ended the quarter on a weak note with no growth in September. Strong domestic demand and a 1.1% advance in business investment (quarter to quarter) were offset by a decline in exports. For 2004, the Canadian economy is expected to expand by about 2.7% with real gross domestic product (GDP) growth to average about the same in 2005 and about 3% in 2006.

The U.S. economy grew at a 3.9% annualized rate in the third quarter of 2004, compared to a robust 4.5% real growth rate in the first quarter and a 3.3% increase in the second quarter. The acceleration in real GDP in the third quarter primarily reflected gains in personal consumption expenditures, increased exports, and reduced imports, the latter two indicators reflecting the lower value of the U.S. dollar relative to other major currencies. Growth for 2004 is expected to reach about 4.5%. Rising interest rates will likely moderate growth in the United States over the next two years to somewhere in the 3 to 3.5% range.

Factors affecting Canada's economy in 2004 included a marked recovery in world economic growth; increasing commodity prices; higher energy costs; the growing presence of China, India and other major emerging-market economies; and, most importantly, a major appreciation of the Canadian dollar relative to the U.S. currency.

The appreciation of the Canadian dollar, reaching over US$0.84 in November, compared to about US$0.77 at the end of 2003, finally seems to be having an impact on the Canadian international merchandise trade situation. The value of Canadian exports declined by 0.5% in the third quarter, the first quarter-over-quarter decline since the third quarter of 2003. Merchandise exports declined in September for the third consecutive month to $36.1 billion (excluding services) as a result of lower exports to the United States, Japan and the European Union. While the recent decline in the value of Canadian exports is a concern, the figures must be kept in perspective. The value of exports of goods and services in the third quarter of 2004 was $468.7 billion (seasonally adjusted at annual rates), more than 7% above year-ago levels. Exports continue to be a major contributor to economic growth. In 2003, exports contributed more than 40% to Canada's GDP and this level is being maintained so far in 2004.

Benefiting from the appreciating dollar, imports of goods and services rose 3.1% in the third quarter compared to the second quarter. Third-quarter imports, at $446.3 billion, are more than 11% above year-ago levels. Merchandise imports in September remained virtually unchanged from the month earlier at $31.0 billion. The combination of lower exports and higher imports has reduced the trade surplus, thus reducing the rate of growth of the GDP. The rise in imports is a reflection of strong domestic demand and has contributed to solid gains in business inventories, production levels and investment levels.

Corporate profits slowed considerably in the third quarter to 2.1% following two consecutive quarters of more than 7%. While mining, oil and gas profits benefited from higher prices, manufacturing profits were hurt by weaker exports. Expectations are that real business investment growth will increase by about 5% this year and by close to 7% in 2005, and will therefore be a key driver for the economy.

Somewhat slower growth at the end of 2003 and early 2004, combined with a core inflation rate below the Bank of Canada's target rate, prompted the Bank to lower its target overnight interest rate a total of 75 basis points from 2.75% at the end of 2003 to 2.0% by April 2004. With Canada's economy expected to remain near its production capacity through 2005 and in an effort to maintain the core inflation level at around 2%, the Bank began raising rates gradually, increasing the target rate by 25 basis points in both September and October of 2004. Downward risk factors such as weaker U.S. demand, declining commodity prices, weakness in Canadian housing markets, or a

continuing strong Canadian dollar will likely forestall rate increases until the latter half of 2005. The November jobs data (see below), combined with the third-quarter economic data, resulted in the Bank of Canada leaving the benchmark overnight interest rate unchanged in December.

Consumer spending increased by 0.7% in the third quarter compared to 0.5% in the second. Domestic demand continues to be rooted in favourable fundamentals – low interest rates, record employment levels, and high commodity prices, personal incomes and corporate profits.

The third-quarter personal savings rate dropped to zero, the lowest level since 1936. So, while consumer spending remains robust, it is at the expense of personal savings. Higher interest rates would likely curtail consumer spending, dampen residential construction activity and encourage personal savings, although rate increases appear unlikely over the next several months.

The "All items" Consumer Price Index (CPI) increased by 2.3% in October 2004 (year over year), mainly because of significantly higher gasoline prices. The CPI, excluding food and energy, increased by 1.0% in October compared to 1.2% in September, 1.2% in August and 1.6% in July. These levels of inflation are not yet indicating price pressures and, with the strong Canadian dollar tempering future price pressures, the CPI is expected to remain below 2% in 2005 and at about 2% in 2006.

Over the first 11 months of 2004, employment has grown by 195 000. All of this increase is a result of full-time employment gains. The number of people employed in Canada (both full- and part-time) surpassed 16 million earlier in 2004 and, as of November, stood at 16 115 000, the highest level in Canadian history. After two months at 7.1%, the unemployment rate in November increased to 7.3%. The modest number of jobs created (an increase in part-time employment was offset by a slight decline in full-time employment) was offset by a higher number of people entering the labour market. One somewhat worrying statistic did emerge from the November data. Employment fell by 18 000 in manufacturing, bringing job losses in the sector since July to 52 000 (-2.2%).

Canadian manufacturers are facing challenges as the Canadian dollar has strengthened relative to the U.S. dollar (it is at its highest value in over a decade). Also a concern to manufacturers is the price of crude oil and its impact on production costs, although crude prices have fallen recently as mild weather in parts of the United States has tempered demand.

The Canadian dollar has been strengthening steadily since early 2002 when it traded at under US$0.63. For the first time since March 1993, the monthly average exchange rate for the Canadian dollar exceeded US$0.80 (in October 2004). In November it surpassed US$0.84 before settling back to the US$0.81-$0.82 range during the last month of 2004. In addition to the weakness being exhibited by the U.S. dollar, the Canadian dollar's strength relative to the U.S. dollar is due to strong domestic growth and the interest rate differential between Canada and the United States. This differential, however, decreased as the United States raised its benchmark rate by 25 basis points in December. High commodity prices resulting from global economic strength has also contributed, as has potential foreign investment in Canada's resource sector. While there may be some uncertainty regarding future resource price movements, indications are that the Canadian dollar will retain its value through 2005, although it will be subject to short-term volatility. The assumption regarding the dollar's strength will be an important determinant with respect to the overall growth in the Canadian economy. If the Canadian dollar weakens appreciably, Canada's growth rate is likely to be stronger than that forecast above.

Growth in the U.S. economy should approach a robust 4.5% in 2004, which is much improved over the 3.0% achieved in 2003 and 1.9% in 2002. The economy grew at an annualized rate of 3.9% in the third quarter of 2004 following increases of 3.3% in the second quarter and 4.5% in the first. In addition to personal consumption expenditures, increased exports, and reduced imports, contributions to third-quarter growth included government expenditures, equipment and software, and residential fixed investment. Fourth-quarter growth will likely remain above 4%.

The U.S. labour market has created a respectable average of about 185 000 jobs through the first 11 months of 2004, although the November total of 112 000 was disappointing. This brought the number of people employed to 140.3 million, the first time the employment level has surpassed 140 million. The unemployment rate has hovered around 5.4-5.5% through the last half of 2004 and will likely average about 5.5% for 2004 as a whole. Next year, the unemployment rate is expected to decline slightly from the 2004 average.

The weakness of the U.S. dollar is a major factor affecting the current economic situation and prospects for the future. Except for those countries whose currencies are tied to the U.S. dollar, the weak dollar makes U.S. exports less expensive. Conversely, imports to the United States tend to be more expensive, again except for imports from dollar-pegged countries such as China, Hong Kong or Malaysia, or those who sell their products in U.S. dollars, such as Japan or Korea. Lower export prices encourage higher export levels, while the more expensive imports tend to discourage imports, thus helping to reduce the huge U.S. international current account deficit currently running at about US$650 billion, or about 6% of U.S. GDP. As weak as the dollar currently is, prospects are good that it may fall even further. Its value is being supported by heavy intervention by Asian central banks in order to keep the value of their exports relatively cheap in

order to support rapid growth in their countries. The U.S. Federal Reserve is expected to gradually but steadily increase interest rates in order to make investing in the dollar more attractive and to reduce inflationary pressures. The December 25-point increase in the federal funds rate brought it to 2.25% at the end of 2004. But if Asian banks decide to reduce their holdings of U.S. dollars, if some of those countries unhitch their currencies from the dollar, or if they decide to invest in other currencies, such as the euro, the U.S. dollar could fall even further.

The U.S. Consumer Price Index rose 0.5% in October 2004 compared to September. The October level of 190.9 (1982-84=100) was 3.2% higher than in October 2003. The compound annual rate for the three-month period ending in October was 3.4%. Energy costs, which declined in each of the preceding three months after advancing sharply in the first half of the year, increased 4.2% in October, accounting for over half of the advance in the overall CPI. The index for all items less food and energy increased at a much more modest pace of 0.2% in October. During the first 10 months of 2004, the CPI rose at a 3.9% seasonally adjusted annual rate (SAAR) compared to 1.9% for all of 2003. The index for energy advanced at a 22.5% SAAR in the first 10 months of 2004. This compares to 6.9% in 2003. Inflation is likely to moderate in 2005. As interest rates rise and the demand for durable goods subside, consumer spending is expected to moderate. In addition, oil prices have recently dropped significantly from around US$55 a barrel to about US$43 in early December.

In an effort to slow the pace of economic growth in China, the People's Bank raised lending rates for the first time in more than nine years in 2004 from 5.31% to 5.58%. While this modest increase will not, on its own, have a significant impact on growth, it sends a clear message that authorities are determined to slow the rapid expansion of their economy to a more sustainable level. Other rate hikes are possible, as is the possibility that China may consider allowing its currency, the yuan, to float against the U.S. dollar. After growing at a real rate of about 9% in 2004, China's growth is expected to moderate to a still very robust 7.5% in 2005.

In Japan, GDP grew very strongly in the first quarter of 2004, with exports and business fixed investment being the main driving forces. Second-quarter growth, however, was weaker, primarily on account of a sharp drop in inventory accumulation and a larger-than-expected decline in public investment. Third-quarter data indicate that the Japanese economy is moving into a slower, but more sustainable, growth path. Employment dropped in October for a second straight month, increasing the jobless rate to 4.7%. Household spending also fell in October for the fifth time in six months. Growth for 2004 should come in around 4.4%, declining in 2005 to about 2.3%.

India's strong economy appears to be slowing somewhat. Smaller harvests are reducing incomes and spending, although strong export gains in manufacturing are underpinning activity. After growing by about 6.5% in 2004, the Indian economy should still post gains of over 6% in 2005.

Growth in other emerging Asian economies continues to be strong, despite the adverse impact of higher oil prices, supported by overall global demand, renewed demand in the information technology sector, generally supportive macroeconomic policies, and strong domestic demand growth. Average growth for the ASEAN-4 (Indonesia, Thailand, the Philippines and Malaysia) is expected to reach about 5.5% in 2004 and to rise at about the same rate in 2005, while for other newly industrialized Asian economies growth is expected to reach 5.5% in 2004 before moderating to about 4% in 2005.

Sharply higher world prices and demand for crude oil and metals have added to already strong growth in the Commonwealth of Independent States (C.I.S.). Buoyant export growth has increasingly been supported by strong domestic demand. Growth is expected to be around 8% in 2004 before moderating to a more sustainable rate of about 6.5% in 2005.

The United Kingdom, benefiting from accommodative fiscal and monetary policies, is enjoying robust economic growth in 2004. Also supporting this growth is the labour market with the unemployment rate falling to its lowest level since 1975. The Bank of England has, however, begun tightening its monetary settings, thereby reducing expected growth in 2005 to about 2.5%, close to its potential.

Other countries in the Euro area are not faring as well. High unemployment levels of about 9% in 2004 and only slightly less in 2005 have resulted in weak domestic demand, especially in Germany where domestic demand actually contracted in the first half of the year. The European Central Bank (ECB) benchmark rate (2.0%) has remained unchanged since June 2003. It is unlikely that the rate will be lowered in an attempt to stimulate economic activity. The ECB also seems reluctant to raise rates despite its concerns regarding near-term inflation. Raising rates would also encourage further appreciation of the euro. Because of the strength of the euro, exports will not likely make a significant contribution to economic activity in 2005. Expansion in the euro area in 2004 is expected to be about 2.2% with growth prospects for 2005 reduced to 2% or less.

In Latin America, economic activity is rebounding from 2003 when growth rates averaged about 2%. Growth in 2004 is expected to average about 5% before slowing to about 4% in 2005. The recovery, however, is uneven. In 2005, growth rates are expected to vary from a high of 4.7% in Chile to lows of 3.5% in Brazil, Venezuela and Uruguay.

Global growth is expected to approach 5% in 2004, its best performance in four years. This robust growth has been spurred on by economic expansion in the United States and China, as well as in much of the rest of the industrialized and emerging market nations. High energy prices and more restrictive monetary policies are expected to slow the acceleration of global expansion in 2005 to a still very respectable 4.3%. The current global current account imbalances, illustrated by the huge U.S. current account deficit, need to be addressed. The United States should boost savings and reduce its reliance on imported goods, thereby helping to reduce the deficit; structural reforms to improve growth prospects in countries outside the United States are necessary and more flexible exchange rate policies in Asia need to be implemented.

Note: Information in this article was current as of mid-December 2004.

Sources: Bank of Canada; International Monetary Fund; RBC Financial Group; Statistics Canada; Scotiabank Group; *TD Economics;* 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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