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The Canadian and World Economic Situation and Outlook

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The Canadian economy has rebounded from the global financial crisis of 1997 and 1998. Commodity prices have generally turned around, responding to the ongoing strength of North American demand and improved prospects in Europe as well as in Japan and other Asian economies. Another major factor supporting the Canadian economy has been the sustained strength of the economy in the United States, which is by far Canada's largest trading partner. Stronger domestic demand, fueled by high levels of confidence, rising employment and relatively low interest rates, has also contributed to Canada's economic performance. It is the environment of low and stable inflation, in conjunction with the above factors, that provides the basis for the current and future strength of the Canadian economy.

Two factors that could destabilize the Canadian inflation picture require close attention and appropriate action if necessary. These factors are: 1) a prolonged, vigorous expansion of the U.S. economy, possibly leading to higher interest rates; and 2) the repercussions arising from the Canadian economy reaching the limit of its production capacity (although precisely where this level is is difficult to determine).

Canada's inflation rate has been low for several years now and that trend continued in 1999. For the first 11 months of the year, Canada's inflation rate (Consumer Price Index) averaged 1.7% above the comparable period in 1998. The rate in November 1999 was 2.2% above the November 1998 level. The core inflation rate, which excludes the food and energy components, has averaged 1.4% for the first 11 months of 1999 and in November was 1.6% above the November 1998 rate. These figures are all within the Bank of Canada's accepted target of between 1 and 3%. For 1999, the CPI is expected to average about 1.7%, rising to 2% or slightly more in 2000 as the Canadian economy continues to grow strongly.

In August 1998, the bank rate stood at 6%. Successive 25 basis point declines brought the rate to 4.75% in early November 1999. In response to a 25 basis point rise in the U.S. federal fund rate in mid-November, the Bank of Canada raised the bank rate to 5%, a 25 point increase. This was the first increase in the rate since August 1998. Because there has been little inflationary pressure and because the Canadian dollar has remained relatively stable, the Bank has been able to follow a relatively accommodative policy, thus enabling the Canadian economy to weather the downturn in commodity prices and allowed it to respond when the demand for commodities returned. With both the Canadian and U.S. economies now growing very strongly, and with only a modest slowdown expected next year, bank rates in Canada are expected to rise by perhaps 50 to 75 basis points by mid-2000. Given this scenario, rising commodity prices, a healthier current account balance, low inflation and a start on debt reduction, the Canadian dollar should strengthen modestly over the next couple of years, averaging about US70¢ in 2000 and over US71¢ in 2001.

In spite of heavy debt loads and a low savings rate, consumer expenditures are expected to increase in 1999 and 2000, encouraged by low interest rates and a significant increase in personal disposable incomes. In 1999, personal disposable income is forecast to rise about 3.2% and, in 2000, to rise by more than 4.5%. These increases are the result of continued job creation, moderately rising wages and reduced tax loads. Canada Mortgage and Housing Corporation (CMHC) anticipates that housing starts will reach 146 500 units in 1999 and 153 200 in 2000, up from the 137 400 recorded in 1998. Sales of existing homes should reach record levels, rising to 333 300 this year and 340 600 in 2000, compared to 314 300 in 1998. Automobile and truck sales are up 6.8% for the first 11 months of 1999 compared to the same period last year. Automobile sales in November were 17.7% above the November 1998 level, while truck sales were up 14.4%.

Manufacturers' shipments declined 0.7% in October to $42.0 billion. October's decline, the first since March 1999, offset the 0.7% increase registered in September. Despite this decrease, the level of shipments reached in October maintains the upward trend that began in the second half of 1998. Business and government investment in plant and equipment is expected to increase to record levels with spending of $135.8 billion in 1999, up 8.1% over 1998. Data from the latest Statistics Canada survey show that investment plans (including housing) have been revised significantly for 1999, with an increase of $9.2 billion over the $165.1 billion that was originally planned. Steady profits, high capacity utilization rates (nearly 84% in the second quarter) and low interest rates are the underlying factors in this spending resurgence.

The level of both exports and imports increased in October. The merchandise trade surplus for October reached $2.7 billion. The continuing recovery in commodity prices contributed to the rise in the value of merchandise trade, as did the demand from a strong U.S. economy and the relatively low value of the Canadian dollar. For the first ten months of 1999, the value of merchandise exports reached $296.3 billion, 11.5% above the corresponding level in 1998. Imports increased more modestly, rising 7.7%, leaving a merchandise trade surplus for the January-October period of $26.9 billion, compared to $15.6 billion for the comparable period in 1998. The improved prospects for commodity markets and the competitive Canadian dollar have translated into a significant swing in Canada's current account suggesting that, by mid-2000, the account may be in a surplus position. (The sum of current account balances over time, which have often been deficits, is Canada's net external indebtedness.) This indebtedness has been a negative factor for Canada's financial markets in the past.

Employment increased strongly in November for the third consecutive month and brings job gains so far this year to 313 000, an increase of 2.1%. Unemployment fell in November and the unemployment rate dropped 0.3% to 6.9%, the lowest level since August 1981. This performance confirms that Canada is in the midst of its most evenly balanced growth period of the decade. Although employment growth is likely to continue, further declines in the unemployment rate will be limited by the continued expansion of the labour force because our participation rate is still well below levels attained before the last recession. So far this year, the unemployment rate has averaged 7.7% and should average about 7.6% for 1999. The sharp drop in the November unemployment rate makes predicting next year's rate more uncertain, but it is expected to decline to the low-to mid-7% range.

Canada and the United States will once again be the top performers of the G-7 countries in terms of real growth. For 1999, Canada's real growth (GDP) should average about 3.75%, slightly lower than the U.S. growth rate. In 2000, Canada's growth is expected to slow somewhat to about 3% in response to a lower U.S. growth rate and moderately higher interest rates. However, the 3% growth rate would put Canada at the top of the G-7 countries next year.

The U.S. economy is turning in another stellar economic performance in 1999, characterized by low inflation and real growth of around 4%. Its GDP increased at an annual rate of 5.5% in the third quarter of 1999, up considerably from the 1.9% increase recorded in the second quarter. Although the U.S. economy created over 300 000 jobs in October, reducing the unemployment rate to 4.1% (the lowest level since early 1970), wage growth was subdued, as evidenced by the fact that hourly earnings increased by only 0.1% in October. Labour markets are exceedingly tight in the United States at the present time and there is no indication that the situation will change, a key risk to inflation according to the Federal Reserve.

U.S. consumers are expected to reduce spending in 2000 after recent years of consumer spending as the main driver of economic growth. Impressive gains in the stock market have allowed consumer spending to grow faster than anticipated. However, with a stock market correction expected within the next few months and with the Federal Reserve likely in the midst of moderate interest rate increases, consumer spending should slow. These interest rate increases, while not large, will have a significant effect as heavily indebted consumers will be very sensitive to even small rate increases.

The large U.S. trade deficit is expected to continue and will slow economic growth. Export growth should pick up as the global economy improves, but the strong U.S. currency will stimulate import growth even more. As a result, the U.S. current account deficit is expected to reach a record high $440 billion by 2001.

Considering the above factors, U.S. real GDP growth should average about 4% in 1999 (the best in the G-7) and slow to about 2.5-3.0% in 2000.

Real GDP in Japan rose by a very strong 2% in the first quarter of 1999, after five consecutive quarters of decline. One half of this GDP increase came from public investment but, more importantly, private demand also contributed to the growth. Reduced public investment moderated the growth in the second quarter. However, there are still weaknesses and uncertainties surrounding the current economic situation. Household confidence is fragile due to falling incomes and job loss fears. Many businesses, especially those less exposed to international competition and pressures for restructuring, are still burdened by large debt loads and excess capacity. There is also a danger that public investment will continue to decline as the effects of earlier stimulus packages wear off. Exports will benefit from the Asian recovery, but the strengthening of the yen in late 1998 and in 1999 is likely to limit growth from exports.

Despite these concerns, the International Monetary Fund (IMF) is forecasting a growth rate of 1% for Japan in 1999 and 1.5% in 2000, particularly if private sector confidence strengthens further. Monetary policy is very supportive of a recovery. Overnight interest rates are effectively zero and 10-year government bond yields are expected to hover around 2% this year and next. Further restructuring of the corporate sector, although already under way, is necessary. The unemployment rate is expected to increase from 4.1% in 1998 to 5% in 1999 and to 5.8% in 2000. Inflation will remain close to zero in both 1999 and 2000.

Other forecasters are less optimistic. With unemployment rising and incomes falling as restructuring continues, they expect the recovery to be hesitant and unlikely to surpass 1% this year or in 2000.

There is continuing evidence suggesting that the United Kingdom is recovering strongly from last year's manufacturing- and trade-induced slowdown. As a net oil exporter, the U.K. will benefit from higher oil prices. Even though the strength of the pound may hinder external trade, manufacturers are trimming costs to remain competitive and global demand is strong. Also, sharp declines in inventory point to the need to replenish stocks, which will further stimulate growth. Given these factors, real GDP growth in 1999 could approach 1.5% and rise to around 2.5% in 2000. After declining by 250 basis points since last October, the Bank of England raised short-term interest rates by 25 basis points in September to 5.25%, reflecting a shift in the Bank's concern from stimulating the economy to heading off inflationary pressures.

A strong economic recovery is also anticipated in the Euro-zone. Accommodative monetary policies are feeding through to interest-rate-sensitive sectors of the economy. Consumer, industrial and construction confidence have all risen. Driven by strong North American demand, strengthening demand in the Asian and East European regions, and accelerating growth in the U.K., export orders are on the rise. GDP is expected to rise by 2.1% in 1999 and by about 2.8% in 2000. Until needed labour market reforms are implemented, however, unemployment will remain high at over 10% in both 1999 and 2000.

The macroeconomic performance of the crisis-hit economies in Asia continues to improve. Positive GDP growth is expected in almost all the countries in 1999. Exports have increased, supported by favourable exchange rates and improved growth in regional trading partners. Recovering commodity prices and an upturn in the electronics sector have also helped underpin the economy. Even stronger growth is forecast for 2000 in most countries as the recent improvements in economic confidence and activity are followed by a broader-based pickup in domestic demand. For Asia (excluding Japan, Hong Kong, Taiwan, South Korea and Singapore), the IMF is forecasting growth rates of 5.3% in 1999 and 5.4% in 2000. While financial restructuring is well advanced, corporate reforms must be implemented in order for the recovery to be sustainable.

South Korea is recovering at a very fast pace, supported by macroeconomic policies, an expansionary fiscal stance, low inflation and a competitive exchange rate. Growth is expected to reach 6.5% this year and 5.5% in 2000.

Recent developments in Latin America have been mixed. For the region as a whole, growth is forecast to be flat in 1999, but could rise to about 4% in 2000. Downside risks remain formidable, however, including policy challenges, a heavy political agenda, and the fragility of financial sentiment.

After some modest growth in 1997 and early 1998, economic activity in Russia again weakened in the wake of the 1998 financial crisis when Moscow defaulted on its foreign debts, sending the ruble into a tailspin. Continuing economic and political uncertainties have led to further capital flight and a decline in foreign direct investment. Some recent developments, however, suggest that the economic decline is being reversed. Industrial output has improved, partly as a result of import substitution related to the weakened ruble. Higher oil prices have also had a positive impact. Monetary policy has remained reasonably firm. As a result, inflation has slowed to around 3% per month or less, gross foreign reserves have increased, and the ruble has been generally stable since April 1999. Taking these factors into account, and assuming the implementation of effective stabilization and reform programs, the IMF has forecast zero growth for Russia in 1999 and 2% in 2000.

As a result of the Russian crisis, growth projections for many neighbouring countries have been downgraded, exchange rates have depreciated, inflation has increased, and fiscal positions have deteriorated. Growth in Hungary and Poland has, nevertheless, held up relatively well with growth for both expected to be 3.7% in 1999 and 4.5-5% in 2000. The Czech Republic economy is expected to be flat in 1999 following a 2.8% contraction in 1998. In 2000, the growth rate is forecast to be 1.5%. The core of the difficulties facing the Czech Republic, Slovakia and many of the other Eastern European countries is the poor financial condition of their banking systems and the slow pace of restructuring in some large industrial enterprises.

In summary, the world economy in general appears to be on the mend following the Asian crisis and subsequent financial turmoil in Brazil and Russia. Oil prices have recovered and declines in many other commodity prices have been arrested. The IMF is forecasting world growth rates to equal 3% in 1999 and 3.5% in 2000. However, uncertainty attached to the world economic outlook will prevail over the forecast period. If the U.S. economy weakens significantly without offsetting gains by Japan and Europe, there would be cause for concern related to the recoveries in the Asian economies and much of Latin America. Perceived or actual Y2K compliance problems are an additional risk. The achievement of a moderate slowdown in the United States, sustained recoveries in the emerging markets and in Japan, and a sustained strengthening in Europe are certainly feasible, but downside risks are present and if these risks occur, the generally positive global picture could change to less upbeat scenarios.

Note: Information in this article was current as of December 20, 1999.

Sources and acknowledgements: International Monetary Fund (IMF); TD Bank; Royal Bank of Canada; Bank of Canada; Canada Mortgage and Housing Corporation; Statistics Canada.