



# 2012-2013 Economic Outlook

## Economy Battles Strong Headwinds: Modest Growth Ahead

### Policy Brief

Economic Policy Series – December 2011

#### Introduction

As 2011 got underway, the global economic recovery seemed broadly on track, but as time has passed, it has seemed less secure. A throng of economic troubles – the rise in energy prices following the Arab Spring uprisings, disruptions to global supply chains caused by Japan’s earthquake, the political stalemate over the U.S. debt ceiling and Europe’s deepening sovereign debt crisis – have put a chill on the global economy.

Fortunately, Canada has fared relatively well. Its sound banking system, comparatively better fiscal position, resilient housing market and strong corporate balance sheets have steered the economy through turbulent waters. There is also a large dollop of good fortune behind Canada’s hardiness. It produces many of the commodities (e.g. crude oil, minerals, base metals and lumber) sought after by the world’s fastest-growing Asian economies.



*The Canadian Chamber is committed to fostering a strong, competitive and profitable economic environment that benefits all Canadians. This paper is one of a series of independent research reports covering key public policy issues facing Canada today.*

*We hope this analysis will raise public understanding and help decision-makers make informed choices. The papers are not designed to recommend specific policy solutions, but to stimulate public discussion and debate about the nation’s challenges.*

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While many of Canada's economic advantages remain intact, ample headwinds will constrain growth in the year ahead. Many of these are blowing in from abroad.

The European sovereign debt crisis remains the most urgent matter facing the global economy. The crisis could send shockwaves across the Atlantic and hit the Canadian economy directly and indirectly through financial, trade and confidence channels. In fact, the crisis has led to a decline in the prices of equities and other risky assets and has pushed credit spreads higher in Canada, albeit less so than in most other countries.

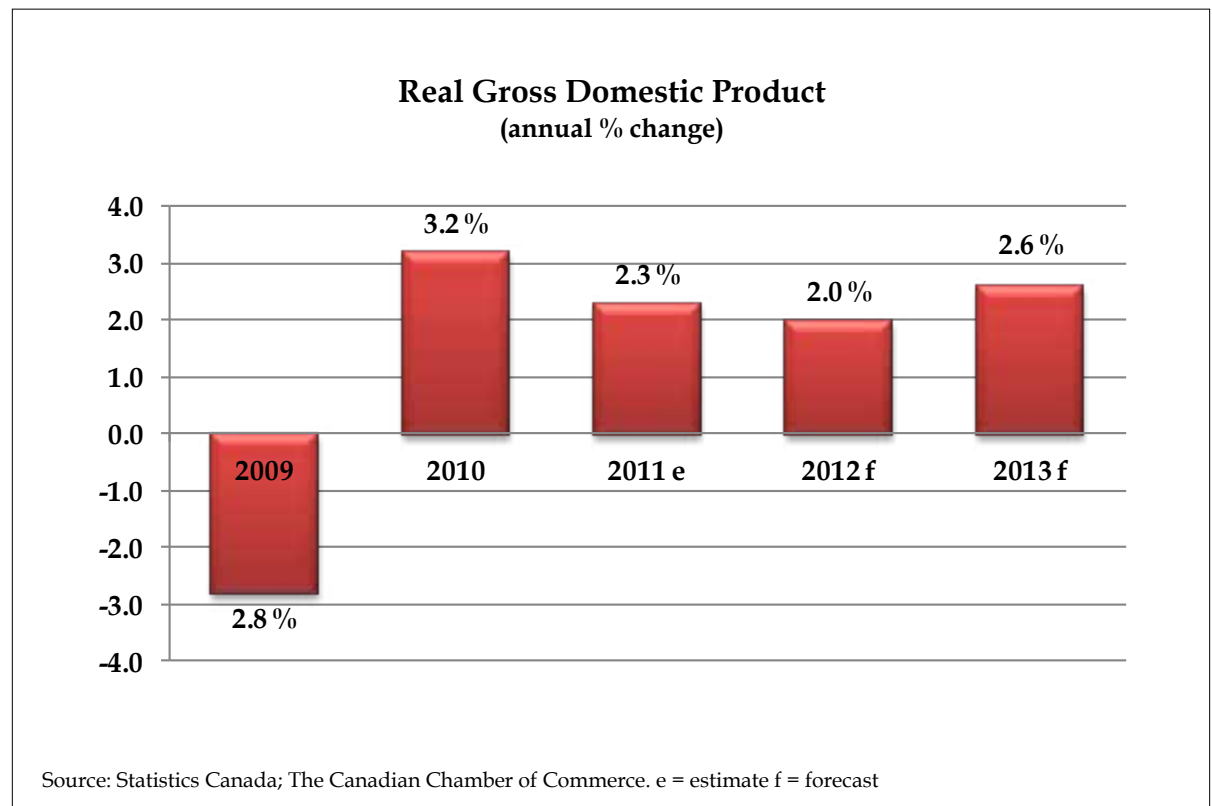
A challenging external environment will also weigh on Canadian exports. Modest economic growth in the U.S. and a still-strong currency are expected to hold back the performance of Canada's export sector, as will cooling demand in emerging-market economies. Shipments to the

euro area are likely to remain weak as the region is in the grip of recession.<sup>1</sup>

On the domestic front, global uncertainty has shaken consumer and business confidence. Canadians are growing more cautious in their spending habits and businesses are more guarded when it comes to hiring.

With these headwinds at play, Canada's economy (i.e. real Gross Domestic Product) is projected to grow a modest 2.0 per cent in 2012, down from an estimated 2.3 per cent rate in 2011 and 3.2 per cent in 2010. The economy is forecast to grow around 2.6 per cent in 2013 reflecting improving sentiment, stronger domestic fundamentals and better growth prospects in the U.S. and abroad.

As with all forecasts, ours are subject to a considerable degree of uncertainty and risk.



<sup>1</sup> The U.S. is the destination of slightly more than 70 per cent of Canadian international shipments. Emerging-market economies take in about 11 per cent of Canada's exports. Around nine per cent of exports are destined for the European Union.

# Economic Growth Is Poised to Continue, Albeit at a Modest Pace

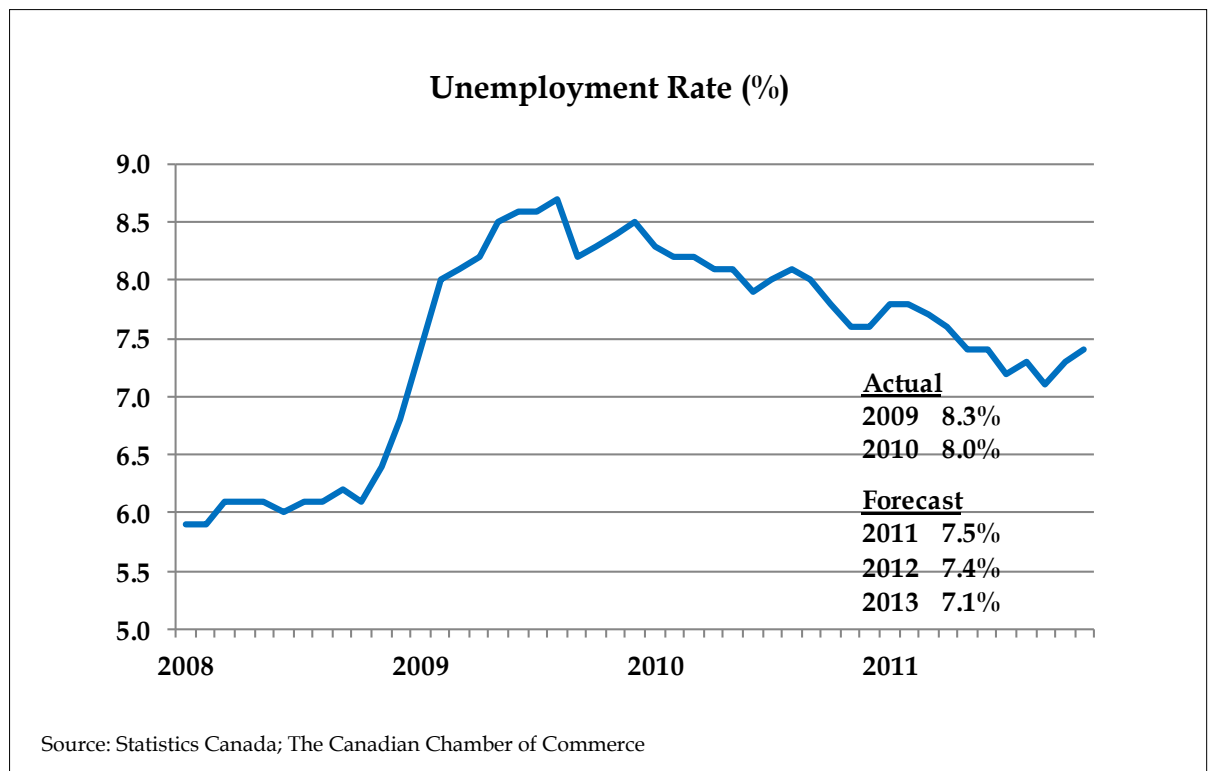
The two key sources that powered rapid growth earlier in this cycle – consumer spending and housing activity – are cooling down. High household debt levels point to further moderation over the forecast period. Additionally, economic activity will be tempered as federal and provincial governments step up their efforts to restrain spending. Business investment remains a bright spot in both 2012 and 2013.

## Canadian consumers are tapped out

The pace of consumer spending has moderated, growing by just 1.2 per cent in the third quarter of 2011. This is a far cry from the 3.3 per cent average pace recorded in 2010. The steady

drumbeat of negative global economic news and heightened volatility in stock markets have taken a toll on consumer confidence. Additionally, employment growth has stalled since mid-year, a sign that employers are more cautious in hiring new workers given the uncertainty in the economic environment.

Going forward, high household debt levels are likely to keep growth in spending relatively modest compared with the rapid pace seen during the recovery. Canadian households owe more than \$1.50 for every dollar of disposable income. As well, growth in personal disposable income will remain subdued, while the pace of hiring is anticipated to remain slow. Finally, there is not much pent up demand in Canada, especially for big-ticket items.

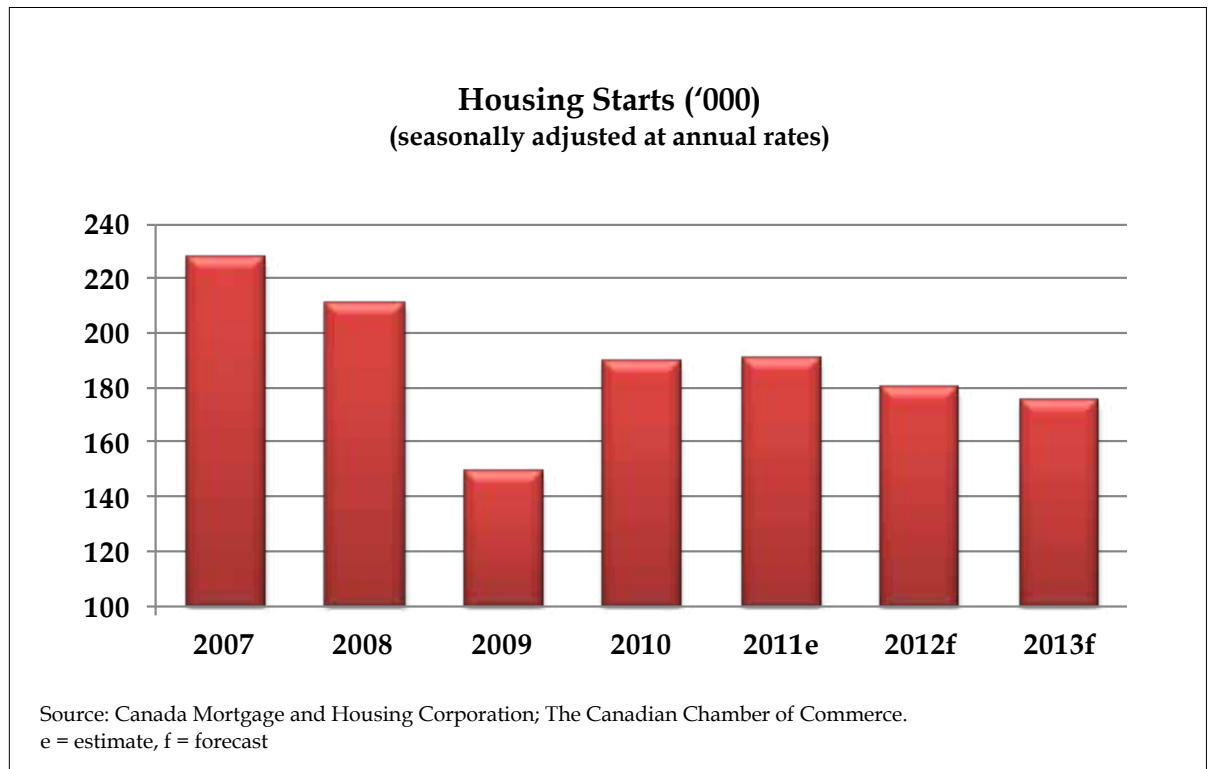


## Housing activity is poised to moderate

Canada's housing market has been surprisingly resilient. Low interest rates will continue to underpin home sales activity, but some easing is expected in the coming quarters due to tightened mortgage regulations<sup>2</sup>, high household debt levels, slower job growth and a heightened

degree of economic and financial uncertainty. With housing demand retreating, housing starts are also expected to recede to levels that are more consistent with the rate of household formation.

Overall, we forecast housing starts to average around 191,000 units in 2011, 180,000 units in 2012 and 175,000 units in 2013.



## Government spending restraint will weigh on economic performance

Fiscal fuel fired up Canada's economic engine at a time when it was sputtering and has contributed significantly to growth since the onset of the recession. Governments have now begun to rein in spending to balance their

books, and central Canada and Atlantic Canada are likely to feel the biggest drag due to their relatively large deficits as a share of GDP.

Thus, government spending will make a considerably smaller contribution to overall real GDP growth in 2012 and 2013.

<sup>2</sup> In March 2011, the federal government reduced the maximum amortization period for new government-backed insured mortgages from 35 years to 30 and reduced the amount Canadians can borrow in refinancing mortgages from 90 per cent to 85 per cent of the value of a home.

## Net exports are expected to remain a source of weakness

Export sales will likely remain soft in 2012 reflecting sluggish foreign demand and ongoing competitiveness challenges, including a still-strong Canadian dollar and weak labour productivity growth.

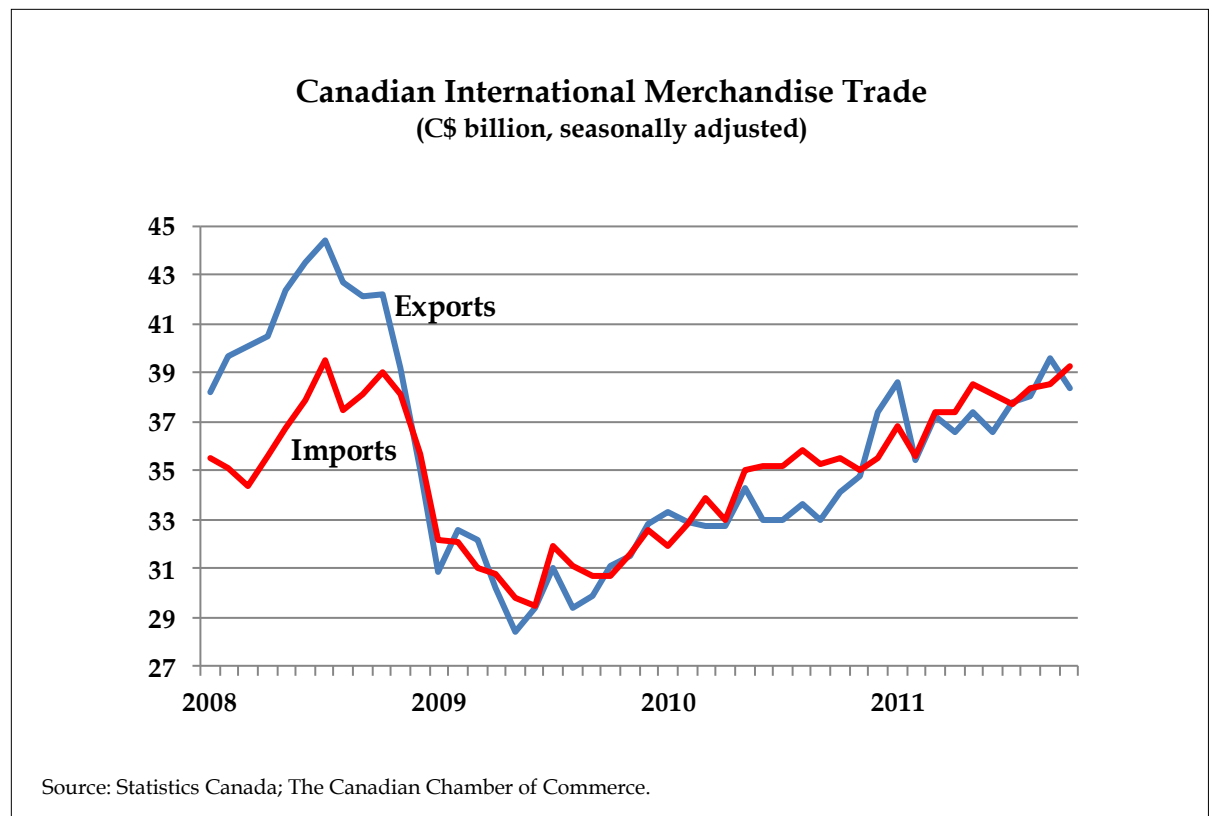
Consumer spending has picked up in the U.S. recently but seems unlikely to serve as a major engine of growth. Although U.S. households have made some progress in repairing battered balance sheets, many still face elevated debt and reduced access to credit. Additionally, high levels of unemployment, lack of real income growth and concerns about the possibility of

further declines in home prices will continue to weigh on U.S. household spending.

Growth in emerging-market economies is moderating but remains relatively strong. And with the euro area in recession, expect Canadian exports to face growing headwinds.

On the other side of the ledger, imports are expected to grow modestly reflecting the expected moderation in Canadian household spending.

In 2013, a pickup in U.S. demand and an expanding global economy should provide support to Canadian exports.



## Business investment will remain a strong support to growth

Canadian businesses have made critical investments in plant and equipment to improve their productivity and competitiveness. Investment in machinery and equipment (M&E) has been particularly robust, steadily increasing over the last two years (with the exception of the third quarter of 2011).

A number of factors support increased capital investment going forward. These include low borrowing costs, high corporate cash balances, the elimination of tariffs on a range of M&E, a favourable business tax environment and the development of new production capacity in the natural resources sector. The high Canadian dollar will also stimulate investment as most of the cutting-edge M&E used in Canada is imported, primarily from the United States.

### Provincial/Territorial Outlook

All provincial economies are projected to expand in 2012, led by Canada's resource-rich provinces in the West (i.e. British Columbia, Alberta and Saskatchewan). Firm commodity prices and resource-sector investments are anticipated to push real GDP growth above the national average in these provinces.

Manitoba's economy is also expected to post real GDP growth above the national average. The province has a stable and well diversified economy, including a very robust manufacturing sector. Its agriculture and mining sectors provide good long-term growth prospects. Manitoba will make major investments in 2012 to repair flood-damaged highways, roads and bridges, adding to its growth. By the end of next year's construction season, more than \$2.8 billion will have been invested in Manitoba's infrastructure.

For manufacturing-intensive provinces (i.e. Ontario, Quebec and New Brunswick), the strong Canadian dollar and soft U.S. demand will temper production and exports. Fiscal restraint will also weigh on growth due to relatively large budgetary deficits (as a share of GDP). Real GDP growth of slightly below the national average is projected for these provinces.

In 2012, economic growth in Nova Scotia, Prince Edward Island and Newfoundland and Labrador will be on the soft side as

public sector capital spending levels off. Low consumer confidence in the U.S. may dampen travel and negatively impact tourism activity in the provinces.

By 2013, Nova Scotia will start to reap the benefits of the \$25 billion naval shipbuilding contract.

In Newfoundland and Labrador, oil production is leveling off but mineral mining and construction activity will continue to drive growth. The deal to finalize the Muskrat Falls hydroelectric project on Labrador's lower Churchill River has been delayed pending final approval. The project could get underway by spring 2012. Public consultations have concluded with respect to the development of the offshore Hebron oil megaproject and construction work is slated to begin in 2012.

Mining activity will continue to drive growth in Canada's North. Recently released figures from Natural Resources Canada show that \$395.5 million was spent on mineral exploration in Nunavut in 2011; \$309.2 million was spent in the Yukon Territory, and \$81.1 million was spent in the Northwest Territories. In Nunavut and Yukon, mineral exploration companies are spending more than previously projected, while in the Northwest Territories, expenditures are lower than projected. The diamond mining industry is reaching a plateau and grassroots exploration investment is lacking.

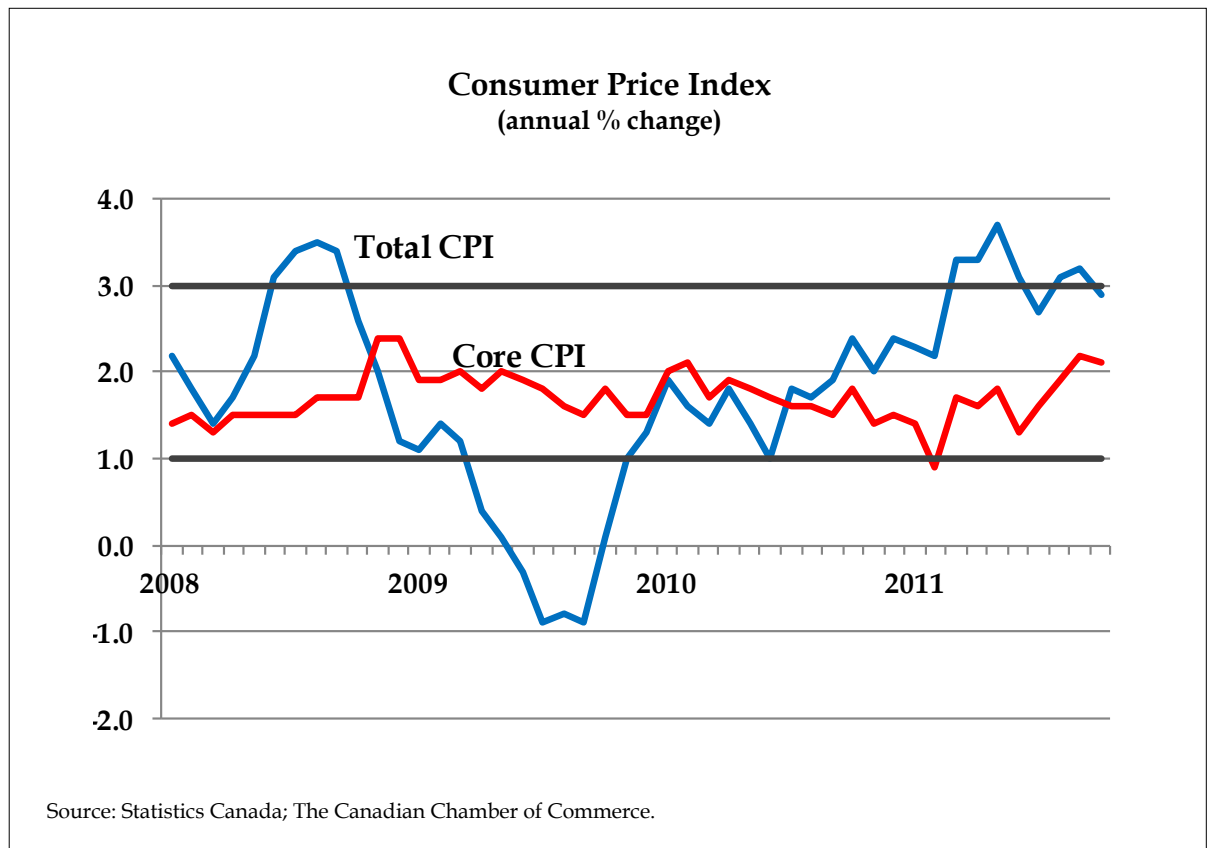
# Inflation Expectations Are Well Anchored

Consumer price inflation, as measured by the year-over-year per cent change in the All-items Consumer Price Index (CPI), has hovered above the Bank of Canada's operational target range (1.0 to 3.0 per cent) for most of 2011, elevated by food and energy prices.

The core rate of inflation, which excludes the most volatile components of the CPI<sup>3</sup>, is more subdued reflecting the persistence of excess supply<sup>4</sup> in the economy, modest growth in labour compensation and the past appreciation

of the Canadian dollar (which reduced prices for imported goods).

Moderate economic growth should keep inflationary pressures in check going forward. In the Bank of Canada's autumn *Business Outlook Survey*, 41 per cent of firms expect inflation to average in the 1.0 per cent to 2.0 per cent range over the next two years, and 47 per cent of firms expect inflation to average 2.0 per cent to 3.0 per cent.



<sup>3</sup> The volatile components of the CPI are fruit, vegetables, gasoline, fuel oil, natural gas, mortgage interest, intercity transportation and tobacco products, as well as the effect of changes in indirect taxes on the remaining components.

<sup>4</sup> Excess supply is the percentage difference between actual output and potential output – the so-called 'output gap'. Actual output is represented by real GDP. Potential output is the level of goods and services that the economy can produce on a sustainable basis without adding to inflation pressures.

# The Bank of Canada Is Expected to Stay on the Sidelines Until Early 2013

In early December, the Bank of Canada announced that it was keeping its benchmark overnight rate at 1.00 per cent, where it has been since September 2010. The Bank said “conditions in global financial markets have deteriorated as the sovereign debt crisis in Europe has deepened.” Offsetting this, “growth in the United States has been slightly more robust than anticipated” while “indicators in Canada suggest that growth in the second half of this year is slightly stronger” and inflation “slightly higher” than projected.

The Bank of Canada has also cautioned that a prolonged period of low interest rates may encourage imprudent risk-taking.

Reflecting all these factors, we believe Canada’s central bank will wait until early 2013 before raising interest rates.

## Canadian Dollar Is Down as Negative Market Sentiment Prevails Over Fundamentals

The Canadian dollar reached a new four-year high of \$1.06 US on July 26, 2011. Since then it has slipped below parity with its U.S. counterpart as investors nervous about Europe’s debt problems have sought safety in the U.S. dollar.

The ongoing turmoil in Europe and investor concern about the outlook for global growth will benefit the U.S. dollar in the near term. Consequently, the Canadian dollar is expected to trade around the 95-cent US level in the first

half of 2012. Canada’s stronger fundamentals—a relatively low level of government indebtedness, a strong banking system, firm commodity prices and a triple-A credit rating—should continue to underpin the loonie.

As risk aversion dissipates, and in anticipation of rate hikes by the Bank of Canada, the Canadian dollar should strengthen and migrate towards parity by year-end 2012 and above parity in 2013.

# In Conclusion

This report provides the Canadian Chamber of Commerce's baseline forecasts based on information available to mid-December 2011. Needless to say, these are very uncertain times for the global economy, and the risks to our outlook and forecasts are significant.

Failure to contain the crisis in Europe is the most serious risk facing the global and Canadian economies. Developments in Europe have intensified pressures on financial institutions in advanced countries, with European banks facing a marked reduction in their access to wholesale funding. The Bank of Canada said "should the crisis deepen and spread further to the larger European economies, transmission to Canada could become more severe, through the credit and funding channels."<sup>5</sup> Most of Canada's banks have limited direct exposure to Europe. Indeed, the disclosed exposure appears to be fairly manageable against a backdrop of strong capital ratios, diversified revenue streams and relatively conservative investment practices.<sup>6</sup>

On the domestic front, the major risk relates to household debt. Because of high debt loads, Canadian households – especially low-income Canadians – are more vulnerable to rising interest rates, job loss and asset price declines than in the past.

Of course, not all of the risks to the outlook are on the downside. The recovery in the U.S. may be stronger than anticipated resulting in higher demand for Canadian exports. Additionally, borrowing by Canadian households may continue to exceed income growth providing a greater impetus to domestic demand than expected. Finally, if Europe's fiscal problems are addressed, Canadian economic growth could be significantly more robust.



<sup>5</sup> Bank of Canada. *Financial System Review*. December 2011.

<sup>6</sup> Ho, Geoff. "Canadian Banks: Exposure to Sovereign Debt." ScotiaMcLeod. June 8, 2011.

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