

Canadian Economic Outlook: 2005 – 2007

**Macroeconomic Forecast for 2004 and
for 2005-2007**

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Executive Summary

- The Canadian economy is on track to record a strong 3.1% rate of growth in 2004, driven by 4.0% growth in the US and 4.7% growth in the global economy.
- Global and US economic growth however have passed their high water mark. The index of leading economic indicators for the OECD, including those for the USA and Canada have rolled over in recent months pointing to a deceleration of economic activity in 2005 and after.
- Economic activity is forecast to continue growing, but at a more modest, yet more sustainable pace over the 2005-07 period. Chinese efforts to restrain the growth in demand appear to be working while the prospects for US growth are darkening.
- The one-time effect of tax cuts in 2004 in the USA is waning while the Fed's campaign to return monetary policy to a more neutral setting will reduce US economic growth in 2005 and after and we expect the US government to be forced to take steps to curb the budget deficit in order to reduce the huge US current account deficit .
- We forecast US growth over the 2005-07 horizon to come in below expectations, and fall below that for Canada. A reduction of the US twin budget and trade deficits calls for a less accommodative fiscal and monetary posture or currency markets will force the US dollar lower. We expect a bit of both.
- Canada will not stay immune to developments south of its border. Lower US growth and a weaker US dollar will weaken Canada's growth prospects through a combination of reduced US demand and a higher exchange rate. Slower global demand will slow demand for Canada's commodities and lower the price of resource and energy exports.
- Canadian growth will also be lowered because both the Fed and the Bank of Canada are obliged to remove the unprecedented monetary policy accommodation they put into place following the 2001 US recession and the 9-11 terrorist attacks. As central banks on both sides of the border move to tighten interest rates to a more neutral setting, private sector demand will slow down over the 2005-07 period.
- Slower growth will come with a silver lining. Reduced growth will ease considerably inflationary pressures and inflation will remain at very moderate levels. Although Canada's economy is operating close to capacity in 2004, the rate of expansion will remain below that of the economy's potential growth rate.
- Low inflation will provide room to central banks to raise rates more slowly and to a more moderate level than is currently anticipated. This means that monetary policy should remain accommodative over the period, which should support growth.

- Canada's economy has come a long way over the past twelve years. The "vicious cycle" Canada found itself in the early 1990s has been now transformed into a "virtuous cycle". With budget and trade surpluses, falling debt levels, high savings and investment rates, corporate restructuring and NAFTA integration, Canada's economy right now is stronger and more resilient than it has been in a very long time.
- Canada's strong fundamentals and greater resilience should help it deal better with the adverse external challenges. We expect a stronger domestic economy to pick up most –though not all- of the slack that will result from a weaker US and global demand.
- Thus, we are forecasting growth to average 2.8% over the 2005-07 period and consumer inflation to remain below 2.0%. With growth below potential and consumer inflation below the Bank of Canada's target, we expect the pace of short-term and long-term interest rate increases to remain more modest than the market is currently anticipating.
- We expect short-term rates to average 3.5% and longer-term rates 5.1% over the 2005-07 forecast horizon with positive implications for growth.
- Although slower US and global demand for Canada's exports should, other factors remaining constant, cause the Canadian dollar to weaken, we expect that the urgency and magnitude of the US budget and trade imbalances to still push our currency to higher levels.
- The major risks to our forecast emanate from forces external to the Canadian environment. First is the risk stemming from the US fiscal and trade imbalances and the potential for significant currency realignments if the US dollar weakens significantly and a yuan and Asian-bloc currency re-valuation. The second risk posed is if the global economy does not weaken substantially due to an inability of Chinese authorities to slow down demand or the Bush administration's unwillingness to address the budgetary challenges. The third risk is related to global geopolitical uncertainties and potential disruptions in the supply of oil. The fourth risk is related to a potential correction in housing markets and its impact on consumer confidence and spending.

The Global Environment

In 2004, the world economy is on track to record its strongest two-year growth performance in thirty years. After reaching its low water mark point in 2001 with a 2.4% growth, global economic growth has since rebounded strongly, expanding by 3.0% in 2002 and 3.9% in 2003. For this year, the IMF, in its September, 2004 World Economic Outlook is projecting a growth rate of 5.0% for this year, but slowing to a more sustainable level of 4.3% in 2005.

The drivers that have propelled the most recent global economic advance are two: 1) the strong recovery of the US economy, engineered by 41-year low interest rates, large tax cuts and expenditure increases, and 2) the emergence of China as a global economic force in the world. With growth averaging 8-9 percent over the past twenty years and with continued market liberalization and economic reforms, the Chinese economy has emerged as the world's third biggest economy accounting for 13% of global output, behind the USA and the Eurozone which account for 21% and 16% respectively, but ahead of Japan which accounts for 7% of global output. While the expansionary monetary policies of the advanced industrial world have nursed economic recoveries in the North American (NAFTA) and EURO-25 region, the emergence of China as the world's newest economic engine has contributed to the economic expansion of Japan and the South East Asian region more broadly which along with Oceania and India now account for almost 33% of the global economy.

China has made its presence felt in global supply, expanding output and reducing product prices as well as in global demand, increasing the demand for capital goods and especially commodities. All resource producing countries including Canada, Australia and Russia have benefited from the rise in the demand and price of resources including, of course the demand for oil and allied energy resources, which have, along with the synchronized global expansion, led to a jump in oil prices to US \$50-\$55 level, the highest since the mid-1980s.

The global economy, however, has passed its high water mark with growth now easing to a more sustainable pace. Many forward-looking economic indicators, including the OECD leading economic indicator covering 30 industrial countries have turned down. Many commodity prices, particularly base metals are forming big tops, a classic sign that world economic growth is about to ease. Growth in the US economy is expected to gear down for 2005 and 2006 in response to rising interest rates, high consumer indebtedness and government fiscal tightening. Growth in the Chinese economy is also expected to gear down somewhat in response to government efforts to hold down demand. Growth in Japan will also ease in response to slower growth in the USA and China while growth in the Eurozone is expected to remain steady. Oil prices are expected to fall to a US \$35 – \$40 per barrel range in 2005 in response to less demand and higher production.

Since the beginning of 2004 many central banks including the Federal Reserve, the Bank of England, the Reserve Bank of Australia, the Bank of Canada and more recently the Peoples' Bank of China have started to raise interest rates in order to return monetary policy to a more neutral setting. Fortunately, the pick-up in inflation in the advanced industrial nations has remained moderate but in many developing countries including China and Brazil inflation has begun to rise. The monetary tightening has been less a reaction to rising inflation but more a pre-emptive move to prevent a significant rise in prices down the road. Moreover, now that the deflationary concerns of 2002 are behind us, central banks are concerned to move rates to a more neutral setting so that they will have the ability to respond to a future slowdown in their economies.

The bottom line effect of central bank policies over the medium term will be to slow down the rate of growth enough to prevent a rekindling of inflationary forces in the global economy, but not enough to precipitate a recession. Rather, tighter monetary policies should contribute to prolonging the global expansion at a more sustainable rate.

Our assessment of the global environment calls for the world economic growth to average 4.7% in 2004 and then slow down to a more sustainable pace of 3.9% in 2005, 3.8% in 2006 and 3.7% in 2007. This forecast is below the IMF forecast, which calls for 5.0% growth in 2004 and 4.3% in 2005. Our forecast for the US economy is that growth will average 4.0% in 2004 and then slow markedly to 2.8% in 2005, 2.6% in 2006 and 2.5% in 2007.

Global Economic Growth Rates					
	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Global Economy	3.9	4.7	3.9	3.8	3.7
United States	3.0	4.0	2.8	2.6	2.5
Canada	2.0	3.1	2.9	2.8	2.7

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The Risks to the Global Outlook

The risks to the global outlook are first the continuing fiscal and trade imbalances of the US economy with a budget deficit close to 5% of GDP and the

trade deficit close to 6% of GDP; second the possibility, albeit small that Chinese economic authorities might fail to hold down the frantic growth in their economy; third, on-going geopolitical threats related to the problems in the Middle East, the war on terrorism, and nuclear threats connected with renegade countries such as North Korea and Iran; and fourth, a potential slump in real estate markets in the advanced industrial countries.

The fiscal and trade imbalances of the United States are clearly unsustainable. The willingness or the ability of Far East Asian central banks to finance the US deficits may lessen, which may cause a jump in interest rates in the US and lessen growth in the North American region, or a further more pronounced weakening in the value of the US dollar or both. Either one of the above two scenarios will have a negative impact on Canada's economic prospects. Higher interest rates and slowing growth in the US is sure to spill over to Canada while a weakening of the US dollar will push the Canadian dollar higher and start making Canadian goods and services less competitive in the US market.

If China fails to hold down its growth to a more sustainable rate, inflationary pressures will mount. As many developing countries such as China, India, Brazil, Poland and the Czech Republic are already dealing with a serious run-up in inflation, it may force central banks to raise interest rates higher, faster with negative implications for global and by extension Canadian economic growth.

The geopolitical risks can impact in a number of unexpected ways, the most obvious being a reduction in the supply of oil and therefore the continuation or exacerbation of high energy prices, which will also threaten global economic growth. Given the inflation-fighting credibility that central banks have earned in their previous fights against oil-induced inflation, higher oil prices instead of resulting in higher inflation now result in lower consumption and hence production. The longer that high energy prices are maintained, the more growth they subtract from industrial, oil consuming countries.

Lastly, there are increasing signs from countries that have been quick to return rates to a more neutral setting such as Australia and the U.K. that housing prices have started to fall. Since the housing price to income ratio in the USA has reached an all-time high while interest rates have nowhere to go but up, the housing markets of advanced industrial nations and those of the U.S. in particular are now extremely vulnerable to either a run-up in interest rates, a slow-down in the economy, or both.

Any adverse developments that might involve any one of the above risk factors has the potential to spread over to the other risk factors with dangerous economic consequences for the global economy and Canada's in particular.

The Canadian Economy in 2004

Economic growth rebounded strongly in Canada in 2004 following a series of negative shocks in 2003 including the severe acute respiratory syndrome (SARS) outbreak, the discovery of a case of bovine spongiform encephalopathy (BSE) in Alberta, forest fires in B.C. and most of all the sharp 18% appreciation in the value of the Canadian dollar. From an average annual growth of 2.0% in 2003 Canadian growth rebounded to 3.0% in the first quarter and 4.3% in the second, surpassing growth in the USA. Growth in the third quarter is expected to exceed 3.3% and close the year at an average annual growth rate of between 3.0% and 3.1%.

Job growth has been equally impressive with the Canadian economy adding 289,000 over the past twelve months and the unemployment falling to 7.1% in October 2004. In the first half of 2004 real personal disposable income per capita rose 3.3% relative to the second half of 2003. Real consumer spending also increased a strong 3.7% over the same period thanks to rising income, higher consumer confidence and historically low interest rates.

These factors have supported continued growth in real business residential investment. Housing starts reached an annualized average of over 229,000 units in the first nine months of the year –the highest level in 17 years.

Corporate profits rose 28.5% in the first half of 2004, and the gain was broadly based. Currently corporate profits in Canada stand at 13.8% of GDP, the highest level in 30 years. Business confidence remains at a high level. More than 50% of firms surveyed by the Conference Board of Canada in the third quarter expect that their financial position will improve over the next six months.

The strength in corporate profits and business confidence has supported business non-residential investment, which rose 6.4% in real terms from the second quarter of 2003 until the second quarter of 2004. Machinery and equipment investment has risen strongly over the first six months of the year, assisted by falling capital goods prices, the result of the appreciation in the currency.

Despite the unprecedented appreciation in the value of the Canadian dollar, exports have rebounded strongly in 2004 after falling back somewhat in 2003. Exports are up 8.5% from last year while imports are up 7.7% over the same twelve-month period. Export growth has been complemented by favourable movements in Canada's terms of trade –prices of exports relative to prices of imports- reflecting in part higher commodity prices. As a result, Canada's current account surplus rose to nearly \$42 billion in the second quarter, the second highest on record and the 20th consecutive quarterly surplus.

Ongoing fiscal and current account surpluses have generated a sustained reduction in Canada's net foreign debt, which as a percent of GDP has fallen to 13.7% in the second quarter -from over 44% in 1992-, the lowest level in almost 50 years. This means that more of the income that Canadians earn stays in Canada. These developments stand in stark contrast to the U.S. where large current account deficits have raised net foreign debt to over 20% of GDP.

The public sector fiscal position in Canada has continued to improve in 2004. The federal government recorded a surplus of \$9.1 billion in 2003-04, or 0.7% of GDP (up dramatically from \$1.9 billion forecast in March), which is the seventh consecutive year since 1997-98 that the federal government has recorded budget surpluses –the first time this has happened since the creation of the country in 1867. Canada has been the only G-7 country to post a budget surplus in 2004 and is expected to do so again in 2004-05 and 2005-06.

The recent string of budget surpluses has permitted the federal and provincial governments in Canada to reduce the public debt. Since 1998 the federal government has reduced its debt by \$61 billion that has produced an annual saving in excess of \$3 billion in interest charges on the debt. Since 1995-96 the total -federal plus provincial- public sector debt has fallen from over 100% of GDP to 65% of GDP in 2003-04, a remarkable achievement.

The bottom line of all these improvements in the domestic debt-to-GDP ratio and the foreign debt-to-GDP ratio is that it has given the country an increasing resilience against future and external economic shocks that will allow the country to better weather any future adverse global economic problems. Moreover, the surplus position of the public sector has led to a “crowding-in” as opposed to a “crowding-out” phenomenon. The private sector has ample funds to finance its activity and contributes to a lower and more stable interest rate environment.

Over the past ten years Canada has managed a difficult transition from a situation of “vicious circle” of high budget deficits, high debt current account deficits, high inflation and high interest rates to a “virtuous circle” of budget surpluses, falling debt, current account surpluses, low inflation and low interest rates. Against this backdrop it should come as no surprise that Canada's currency has appreciated against the US and other world currencies since the end of 2002. A strong Canadian dollar will help keep inflation low in Canada, boost productivity, and mitigate against the need to raise interest rates too high thus contributing to faster growth in output and living standards.

In contrast to Canada's picture that has brightened considerably over the past ten years, the picture in the US, Canada's biggest trading partner has dimmed decidedly. From a “virtuous circle” in the 1990s, whereby strong economic growth led to a strong dollar, low inflation, low interest rates budget surpluses and falling debt levels the US economy has entered a “vicious circle”

whereby budget deficits lead to current account deficits, rising domestic and foreign debt, falling currency and soon higher inflation and higher interest rates which will greatly complicate the macro economic management of the country.

Big conflicts exist between domestic and external balance in the US. The very policies needed to promote recovery and expansion result in higher trade deficits, while to reduce the trade deficit the US needs tighter fiscal and monetary policies that will result in slower growth. A difficult period of adjustment lies ahead for the U.S.

The Medium Term Forecast for Canada: 2005-2007

The global economic expansion of the past three years that contributed to Canada's strong 3.1% growth in 2004 has now peaked. Leading economic indicators suggest that the global economy will continue to expand but at a slower and more sustainable pace over the 2005-2007 period. We expect global growth to average 4.7% in 2004, 3.9% in 2005, 3.8% in 2006 and 3.7% in 2007. The bottom line effect is to moderate global inflationary pressures and reduce the degree of monetary tightening required to control inflation. Commodity and energy prices should ease from this year's highs and this should slow the growth in Canadian exports and moderate the advance in the Canadian dollar.

We expect growth in the United States of America, our biggest trading partner to average 4.0% in 2004, but downshift substantially to 2.8% in 2005, 2.6% in 2006 and 2.5% in 2007. The reasons we expect the US economy to under-perform over this time horizon is that monetary policy will be tightened substantially –a necessary move toward a more neutral setting; that fiscal policy will be tightened as well in order to reduce the large fiscal imbalance that has opened since 2001 and a retrenchment in consumer spending as US consumers respond to rising interest rates and high consumer debt levels. This forecast for the US economy is considerably less bullish than market forecasts that see the US economy expanding at a 3.5% annual rate in 2005.

The bottom line implication of the above forecast for the US is that the output gap in the US economy will persist through the medium term which will restrain the pricing power of US corporations, contain inflation and reduce the extent to which the Fed will have to raise interest rates. At the same time, as the US growth is seen to under-perform expectations, it will cause renewed downward pressures on the US dollar which will set new lows for the greenback and push the Canadian currency to new highs. Since the US is Canada's biggest trading partner, it will drag down growth in the Canadian economy and also reduce the degree of monetary tightening that will take place on this side of the border.

We forecast Canadian growth of 3.1% in 2004, moderating slightly to 2.9% in 2005, 2.8% in 2006 and 2.7% in 2007. Our forecast is more or less in line with

the average of private sector forecasts conducted in September, 2004 for the Department of Finance, (see Table) which see growth of 3.0% in 2004, 3.2% in 2005, 3.1% in 2006 and 2.9% in 2007-09 period. We expect slightly higher growth for 2004, but modestly lower growth for 2005-07. Our forecast is also substantially lower than the average of the “big banks” consensus forecast, which project growth of 3.3% in 2005 and 3.4% in 2006. We forecast Canadian growth to be slower than other forecasters because of the down-shifting in the rate of global expansion and US growth in particular will spill over in to Canada.

On the other hand, we expect the negative impacts emanating from the US and global economy to be buffered to a considerable extent by Canada’s improved economic fundamentals which have greatly enhanced the country’s resilience to external shocks. Strong gains in employment, lower taxes, higher government spending and higher business capital investment expenditures should boost domestic demand in the face of considerably lower external demand.

We expect inflationary pressures in Canada to remain well contained. We forecast consumer inflation of 2.0% in 2004, 2.0% in 2005, 1.7% in 2006 and 1.6% in 2007. Our forecast here is slightly lower than private sector and “big bank” forecasts because we expect slightly lower growth than they do. The low inflation environment, in conjunction with our forecast for growth below the economy’s potential growth rate should obviate the need for significant rate increases in 2006 and 2007.

The Bank of Canada will continue on the monetary tightening drive it embarked on in August, 2004 to return interest rates to a more neutral setting in the short-run. We expect the central bank to raise the benchmark overnight rate to 2.75% in December, 2004, and then raise rates by 50 basis points in the first half of the year to 3.25% and by another quarter point to 3.5% by the end of 2005. In all we expect the 3-month rate to average 3.2% in 2005 (up from 2.2% in 2004), 3.8% in 2006 and 4.0% in 2007. Our forecast for the 3-month treasury bill is considerably lower than that of the private sector average forecast which calls for 3.2% in 2005, 4.4% in 2006 and 4.7% in 2007. The reason we expect lower interest rates is because we forecast slower growth for Canada, lower inflation and a stronger currency all of which should keep growth well within the economy’s potential growth rate and therefore obviate against the need for higher rates.

Our forecast for the ten-year Government of Canada bond yield parallels that of short-term rates. We forecast that the bond yield will average 5.0% in 2005, compared to an average of 4.6% in 2004, 5.2% in 2006 and 5.1% in 2007.

The private sector economists forecast an average rate of 5.0% in 2005, but to increase to 5.7% in 2006 and average 6.0% for the 2007-09 period. We don’t buy this forecast in the face of slower growth and low inflation. Unless any

of the global risk factors mentioned above precipitate a global monetary crisis or run-up in inflation, we believe that Canadian bonds yields will trade within a range of 4.9% to 5.3%, averaging 5.1% through the forecast period. We expect that a stronger currency, a low and stable interest rate environment and modest growth to contribute to lower long-term rates than those currently anticipated.

Our forecast for the Canadian dollar is more bullish than the average for the Canadian "Big Banks". We forecast the value of the Canadian dollar at USD 0.8250 for 2005, USD 0.8500 for 2006 and USD 0.8300 in 2007. The average of bank economists for the same period –based on our October survey of expectations- is USD 0.798 for 2005, USD 0.809 for 2006 and USD 0.832 for 2007.

The main reason we forecast a stronger Canadian dollar is that we expect the US dollar to weaken by more than market analysts expect at this time. There are two conflicting forces that will decide the direction and the level of the loonie. On the one hand, slowing global demand for Canadian commodities including energy and slowing US demand for Canadian exports will combine to reduce the value of the Canadian currency. On the other, the US fiscal and trade imbalance will force the US dollar lower which will conversely push the Canadian higher. Our assessment is that the second force, i.e. US dollar weakness will predominate in 2005 and 2006 while the first force, i.e. slowing demand for Canadian exports will increasingly assert itself pushing eventually the Canadian dollar lower, to the 83 cent range.

The outcome of the above scenario, i.e. slower growth and higher currency is why we expect the pace of interest rate increases over the forecast horizon to be considerably more moderate than markets anticipate at this time.

THREE YEAR ECONOMIC FORECAST FOR CANADA: 2004 AND 2005 - 2007

	2003	2004	2005	2006	2007
Nominal GDP Growth, Current \$, (%)	5.3	6.3	5.1	4.7	4.5
GDP Chain-type Deflator Change (%)	3.2	3.1	2.1	1.9	1.8
Real GDP Growth (%)	2.0	3.1	2.9	2.8	2.7
Employment Growth (%)	2.2	1.8	1.7	1.6	1.5
Unemployment Rate (%)	7.6	7.2	6.8	6.7	6.9
Real Personal Disposable Income (%)	1.5	3.2	3.0	2.9	2.4
Consumer Price Index (CPI) Change (%)	2.8	2.0	2.0	1.7	1.6
3-Month Treasury Bill Yields (%)	2.9	2.2	3.2	3.8	4.0
10-Year Government Bond Yields (%)	4.8	4.6	5.0	5.2	5.1
Prime Lending Rate (%)	4.7	4.0	5.1	5.5	5.7
Canada-US Exchange Rate (US/CAD)	0.7158	0.771	0.8250	0.8500	0.8300
Long vs Short Fixed-Income Spread	1.94	2.36	1.80	1.40	1.10
Real Short-term Interest Rate	0.05	0.24	1.20	2.10	2.40

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Average of Private Sector Economic Forecasts for Canada, September, 2004

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007-09</u>
Real GDP Growth	3.0	3.2	3.1	2.9
GDP Inflation	3.1	2.1	1.8	1.7
Nominal GDP Growth	6.2	5.3	5.0	4.7
3-month Treasury bill rate	2.1	3.2	4.4	4.7
10-year GofC bond rate	4.7	5.0	5.7	6.0

Department of Finance Economic & Fiscal Update, November 16, 2004