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OCTOBER 2012

EUROPEAN SOVEREIGN DEBT CRISIS: WILL THE CALM SPELL LAST?

The sovereign debt crisis has been troubling Europe for two years now. It started in 2010, when Greece revealed the scope of its debt and of its public deficit (respectively 115% and 13% of GDP at the time, according to the IMF), which had become unsustainable. The global economic crisis had exacerbated fears among Greece's creditors, who doubted that the country would be able to honour its debts, or even pay the interest. The real state of Greece's public finances was then revealed, showing that they were in far worse shape than the country had been claiming, due to off-balance sheet loans.

In the fall of 2010, the crisis spread to Ireland, although its situation was very different from that of Greece. Ireland had actually enjoyed some boom years before falling victim to the sub-prime mortgage crisis, which caused its real estate sector to collapse and triggered a serious banking crisis. Ireland's public finances deteriorated because the government was forced to take vigorous action to rescue its banks. In the spring of 2011, it was Portugal that found itself in a critical situation: its public finances were in a similar condition to those of Greece (the public debt and budget deficit stood at 100% and 10% of GDP respectively), although it was forthright about the situation. Meanwhile, Spain was also suffering the effects of a burst real estate bubble and was obliged to bail out its banks, even though it was already heavily in debt. Despite significant austerity measures implemented in the spring of 2012, the country has not managed to reach its deficit reduction targets.

At the very beginning of the crisis, in 2010, the European authorities, in collaboration with the International Monetary Fund (IMF), set up a rescue plan for Greece, contingent on the adoption of a budget austerity plan that would repair the country's public finances. To prevent a contagion effect, they also created the European Financial Stability Facility (EFSF) designed to buy the debt of countries finding themselves in difficulty, and set up procedures for granting that assistance, the European Financial Stabilization Mechanism (EFSM). After trying in vain to resolve their public financing problems, Ireland and Portugal and, more recently, Spain were finally forced to draw on the EFSF.[1]

Despite these initiatives, the situation remains critical. The austerity programs implemented not only by the countries that have received aid, but also by many others that are at risk, such as France and Italy, have plunged the euro zone ▼

BDC's Monthly Economic Letter is prepared by the Economic Analysis team from Marketing and Public Affairs and is based on a variety of public sources of economic data. The information in this letter is drawn from data released prior to October 6. Reliance on and use of this information is the reader's responsibility.

1 We should point out that Spain received assistance to recapitalize its banks, but not to refinance its debt, as was the case for Greece, Ireland and Portugal. The Spanish government is reluctant to apply for this form of aid, which would require it to abide by the policies dictated by the European Union.

into recession. But three recent events mark a turning point in the crisis, according to *The Economist*.[2] The first is the ratification of the European Stability Mechanism (ESM) by Germany. The ESM, which will take effect in October 2012, is a permanent tool for dealing with financial crises, which will replace the aforementioned EFSF and EFSM. It will have a lending capacity of 500 billion euros provided by the 17 countries of the zone, on a pro rata basis according to their contribution to the capital of the European Central Bank (ECB). Germany, which was advocating fiscal interventions by the countries in difficulty as a way of resolving the crisis, was the last country of the zone to support the ESM.

The second event was the European Commission's adoption of a single bank monitoring mechanism. Under this new, centralized mechanism, the ECB will assume, for all of the euro zone's banks, ultimate responsibility for carrying out specific monitoring missions regarding the financial stability of the 27 countries of the European Union.

The third event, and certainly the one with the greatest impact, was the ECB's announcement of an unlimited program to buy up the public debt of countries that request it and that agree to introduce profound economic reforms. Until now, the ECB had not intervened so directly to support countries that were in trouble. In fact, Germany was opposed to it. In the German central bank's view, the ECB's intervention consists in bailing out the struggling countries by printing more money, which contravenes its mission of preventing inflation. Having said that, the ECB has pointed out that these buy-up operations would be sterilized, precisely to prevent an increase in liquidity in the system, which would generate inflation.[3]

The ECB's announcement was favourably received by the financial markets, and quickly resulted in a drop in the yields of the bonds issued by the troubled countries. This calm spell is welcome, but will it last? The fact of the matter is that the public finances of the troubled European countries cannot be straightened out overnight. On the contrary: this effort depends on major structural reforms that will take many years to bear fruit, assuming that the countries succeed in adopting them. The ECB and the euro zone leaders will have to convince the financial markets that this is possible, and that they must be patient. In short, Europe is not out of the woods yet. ■

CANADA

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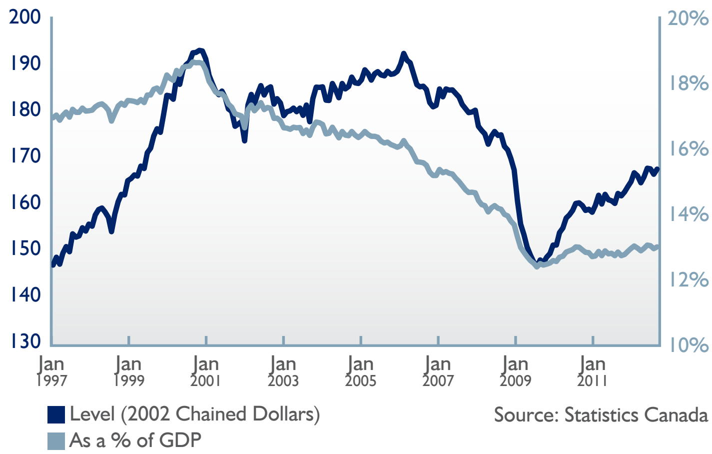
Real GDP growth in July, housing starts growth in August and higher employment in August and September bode extremely well for the third quarter of 2012. The same cannot be said for the foreign trade data, Canada's trade surplus with the United States having reached its lowest point in July since October 2010.

Real GDP continues to rise

Real GDP by industry rose by 0.2% in July, after increasing by 0.1% in June. The sectors that participated the most in that growth are manufacturing, utilities, wholesale and retail trade, finance and insurance and accommodations and food services. The manufacturing sector is gradually turning the corner, after being tested for many years by competition from the emerging countries and the appreciation of the Canadian dollar, and then suffering the effects of the recession. The manufacturing sector's share of GDP, which reached a high point of 19% at the start of the 2000s, now stands at just 13% (see graph).

Manufacturing Production in Absolute Terms and as a Proportion of GDP



Source: Statistics Canada

1 The Economist, September 15, 2012: "The euro crisis: Game change?"
2 When the central bank buys bonds on the secondary market, it injects cash into the system. To "sterilize" the operation, i.e. avoid having it increase the money supply, the central bank encourages the financial institutions from which it has bought the bonds to invest the money they receive in securities issued by the central bank. As a result, an institution that formerly held Portuguese government bonds, for example, would hold bonds issued by the ECB instead. This is to the financial institution's advantage, because the risk associated with ECB securities is lower than that linked with the securities that were bought up.

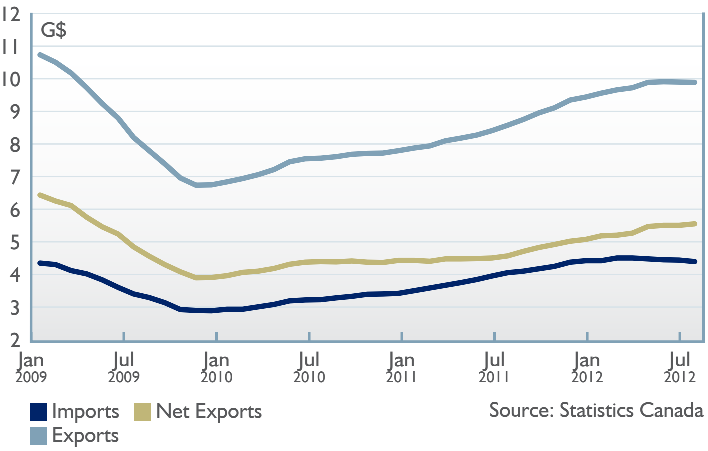
Employment shows healthy growth

After a gain of 34,300 jobs in August, employment increased by 52,100 jobs in September. The unemployment rate nevertheless rose slightly, from 7.3% in August to 7.4% in September, due to expansion of the labour force. Job growth was stronger for full-time jobs (44,100) than for part-time jobs (8,000). Ontario enjoyed the highest gains (31,100), followed by Quebec (10,600) and Manitoba (6,600). Industry-wise, it was wholesale and retail trade, construction and information, culture and recreation that recorded the largest gains, but these have merely counterbalanced the losses sustained in previous months, with the result that employment has made barely any headway in those three sectors in the past 12 months. Lastly, employment dipped slightly in the manufacturing sector.

The trade balance deteriorates

In July, a greater decrease in exports than in imports (-3.4% versus 2.2%) caused the trade deficit to expand, from $1.9 billion in June to $2.3 billion in July. The drop in exports comes mainly from the energy products sector, while the decline in imports also comes from that sector, but from machinery and equipment as well. Net exports of energy products have followed an upwards trend since the beginning of 2010, but have stabilized in recent months (see graph). Meanwhile, Canada's trade surplus with the United States reached $2.1 billion in July, its lowest level since October 2010. On the other hand, the trade deficit with other countries shrank.

Trend in Exports and Imports of Energy Products
(12-month moving average)



Housing starts keep rising, but sales of existing homes decline

The total number of housing starts climbed from 208,000 units in July, to 224,900 in August. The increase is mainly attributable to the launch of some large projects in the Toronto area, reflecting presales carried out at the end of 2010 and beginning of 2011. The Canada Mortgage and Housing Corporation is still calling for a slowdown in residential building activity by the end of 2012 and in 2013. As for sales of existing homes, they tumbled by 5.8% in August compared with the previous month, and that slump was generalized across most of the country's large, urban centres. According to the Chief Economist of the Canadian Real Estate Association, the August numbers would seem to indicate that the changes to mortgage rules, which were intended to cool the market, have achieved their objective.

Retail sales stall

Retail sales were up by 0.7% in July, after dipping by 0.3% in the previous month. It was sales of motor vehicles and parts that supported retail sales growth in July, followed by general merchandise stores. Retail sales have advanced strongly since the beginning of January 2009, but they have been flat since the last quarter of 2011, in terms of both value and volume (see graph). ■

Retail Sales

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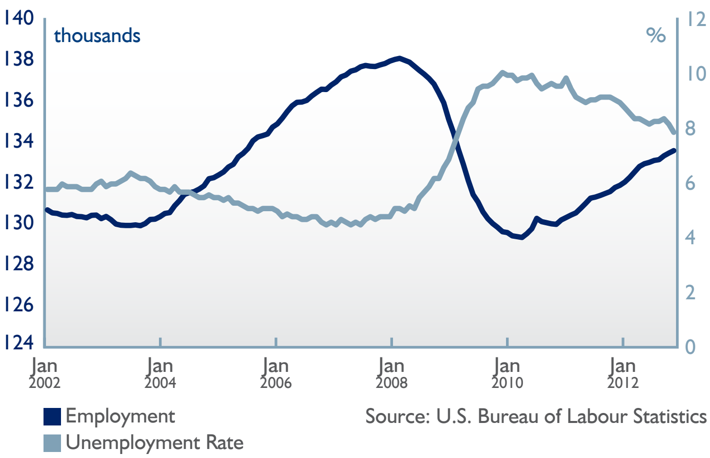
The most recent economic indicators show that the U.S. economy is slowly picking up steam: employment continues to grow at a moderate pace, the housing market is continuing its ascent one step at a time, and the manufacturing sector, after going through a rough patch, seems to be getting back on track.

Employment continues its rally

The labour market expanded by 114,000 jobs in September, after a gain of 142,000 jobs in the previous month. During the first nine months of 2012, employment has advanced by an average of 146,000 jobs per month, compared with 153,000 in 2011. The unemployment rate has dipped by 0.3 %, standing at 7.8%, its lowest point since January 2009 (see graph). It was the health care sector and transportation and warehousing that recorded the largest gains. In manufacturing, employment contracted for the second month in a row.

Employment and Unemployment Rate



Source: U.S. Bureau of Labour Statistics

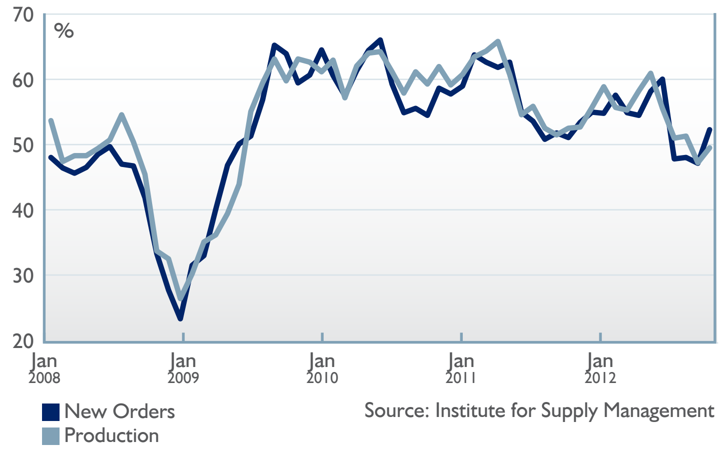
The housing market resumes its slow ascent

The number of housing starts rose by 2.3% in August compared with July, from 733,000 to 750,000 units. Starts of single-family homes climbed by 5.5%, while multi-family starts declined by 2.8%. In the resale market, both sales and the median price of homes were up in August compared with the same month last year, by 7.8% and 9.5% respectively. The inventory of homes for sale expanded by 2.9% from July to August. At the current pace of sales, it would take 6.1 months to sell off the inventory of homes listed, compared with 6.4 months in July.

Confidence rebounds in the manufacturing sector

After three straight months of decline, the Purchasing Managers' Index for the manufacturing sector, compiled by the Institute for Supply Management, climbed back above the 50% threshold in September, reaching 51.5%. The new orders index surged up by 5.2 percentage points, reaching 52.3%, while the production index stayed below the 50% mark despite an increase of 2.3 percentage points (see graph). The September data would seem to indicate that the manufacturing sector has merely gone through a rough patch, and that production should pick up steam in the months ahead. ■

Purchasing Manager's Index for the Manufacturing Sector



Source: Institute for Supply Management

INTEREST RATES

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The key interest rate should sit tight at 1.0% for several months to come

The Bank of Canada's next key interest rate announcement date is October 23. The day after that, the central bank will publish its Monetary Policy Report, in which it will present its analysis of the global, American and Canadian economic situations and reveal its forecasts of economic growth and inflation. The BoC's key interest rate has held steady at 1.0% for two years now, and given the fragility of the global and American economies, forecasters are not anticipating any increase between now and the end of 2013. As for the Federal Reserve, it has declared that its benchmark interest rate will probably remain unchanged until mid-2015, so the spread between the Canadian and American rates will remain stable for several months to come. ■

Key Interest Rates

Source: Bank of Canada and the U.S. Federal Reserve

OIL AND THE LOONIE

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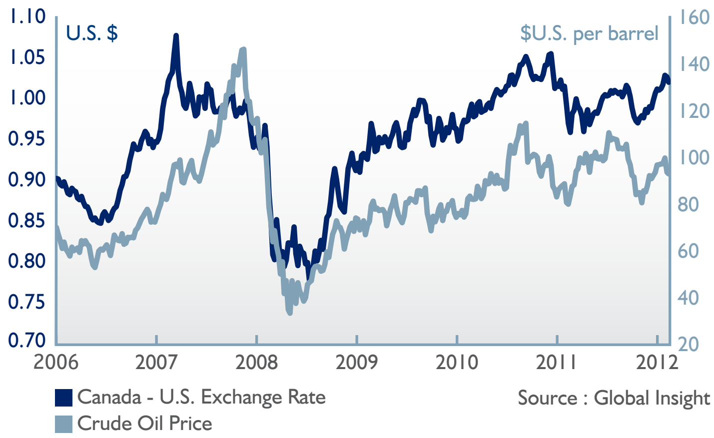
The price of oil and the Canadian dollar dip slightly

Crude oil prices have lost a bit of ground in recent weeks. Despite something of a lull in the sovereign debt crisis, the euro zone economy is still a source of concern for investors, and the disappointing results of Chinese manufacturing indicators have stoked fears of a decline in global demand for oil. The price slump was held in check, however, by persistent tensions in the Middle East, in particular between Iran and Israel, where a conflict could disrupt the region's oil production. ■

Crude Oil Price and Canada - U.S. Exchange Rate



Source : Global Insight

SME CONFIDENCE

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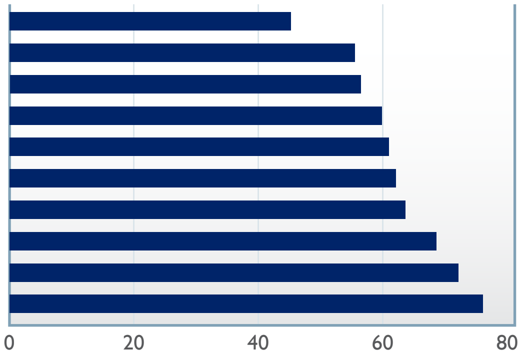
SME confidence improves

After five drops in a row, the Business Barometer Index compiled by the Canadian Federation of Independent Business gained 2 points in September, coming in at 62.0. The index rose in 9 of the 13 sectors monitored. The most optimistic SMEs are those in the information, arts and entertainment and business services sectors. In the hospitality, agriculture and natural resources sectors, SMEs are the least optimistic. Across the provinces, the variations are more pronounced: Newfoundland and Labrador – where the economy is being stimulated by many investment projects – is leading the way, with an index of 75.0 in September, while at the other end of the scale, the Prince Edward Island index – where potato harvests are suffering from bad weather – comes in at just 44.6 (see graph).

Business Barometer Index



Source: Canadian Federation of Independent Business

BUSINESS CREDIT CONDITIONS

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Credit granted to businesses by the chartered banks remains strong

In August, short-term credit granted to businesses by the chartered banks escalated by 22.1% compared with July, while long-term credit rose by 4.8%. The annual growth in total bank credit to businesses has reached 10,1%, its highest rate since November 2008 (see graph).

Business Credit from Chartered Banks
(year-over-year percentage change)

Source: Bank of Canada

KEY INDICATORS – CANADA

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Key indicators – Canada	Historical				2012				Latest		Forecasts	
	2008	2009	2010	2011	Q1	Q2	Q3	Q4			2012	2013
Real GDP (% growth)	0.7	-2.8	3.2	2.4	1.8	1.8			Jul	0.2	2.0	2.0
Machinery and Equipment Expenditures (% growth)	-0.5	-19.5	11.8	12.5	4.0	7.2					3.0	6.2
Pre-Tax Corporate Profits (% growth)	11.0	-33.1	21.2	15.4	-14.0	-17.5					0.5	4.5
Industrial Production (% growth)	-3.1	-9.5	4.9	3.5	-1.2	2.5			Jul	0.4	1.9	3.1
Industrial Product Prices (% growth)	4.3	-3.5	1.0	4.6	0.9	0.5			Aug	-0.1	0.9	1.9
Non-Residential Construction (% growth)	7.9	-22.2	2.8	13.7	7.4	11.4						
Housing Starts (' 000 units)	212	148	191	193	206	230			Aug	225	206	181
Personal Expenditures (% growth)	3.0	0.4	3.3	2.4	0.7	1.1					1.7	2.0
Consumer Price (% growth)	2.4	0.3	1.8	2.9	2.1	0.1			Aug	0.2	1.8	1.9
Employment (% growth)	1.7	-1.6	1.4	1.5	0.9	2.8	1.5		Sep	0.3		
Unemployment Rate (%)	6.1	8.3	8.0	7.5	7.4	7.3	7.4		Sep	7.4	7.3	7.2
SMEs Confidence Index (CFIB)	56.1	57.7	66.7	66.4	66.3	64.4	61.0		Sep	62.0		
Manufacturers Confidence Index (CFIB)	52.7	56.0	68.6	67.2	69.0	67.2	65.3		Sep	62.8		

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business. Annual growth, quarterly growth at annual rate and month-over-month growth.