

economic LETTER

MAY 2012



CHINA: TOWARDS A FLOATING EXCHANGE RATE REGIME?

For many years now, the West has been reproaching China for keeping the yuan below its balanced value, that is, the value that would be determined by global supply and demand for the currency. Normally, other countries' appetite for Chinese products, leading to increasing demand for the yuan, would, in a floating exchange rate regime, have caused it to appreciate over time. But in fact, China does not practise a floating exchange rate policy. Instead, it uses what is called a "managed float" system.

In 2005, the People's Bank of China abandoned its fixed exchange rate policy – the value of the yuan was pegged to that of the U.S. dollar – in favour of this managed float exchange policy, which allows the yuan to fluctuate within a certain range around a pivotal value. That pivotal value, set daily by the Chinese central bank, is equivalent to the average of the yuan exchange rates against a basket of currencies (including the yen, the euro and the U.S. dollar). Initially, the fluctuation margin was set at 0.3% per day, then it was expanded to 0.5% in 2007. After returning to a fixed exchange rate in mid-2008, to prevent the financial crisis then plaguing the West from triggering a strong appreciation of the yuan, China reinstated its managed float exchange system in July 2010.

On April 23, the fluctuation band was widened, from 0.5% to 1.0%. This decision by the People's Bank of China was welcomed by the West as "a step in the right direction"; obviously they are hoping that China will eventually adopt a floating exchange rate. In September 2011, the Chinese central bank did hint that it intended to do just that by 2015. This was not the first time the central bank indicated that intention; but the expansion of the fluctuation margin in April lends greater credibility to the statement.

In the long run, China will eventually be forced to allow its currency to float freely. By maintaining the yuan below its balanced level, it is indeed stimulating its own exports, but this comes at a price. To prevent the yuan from appreciating, the central bank has to expand the supply, that is, put more yuans into circulation. This has the effect of keeping interest rates artificially low, which triggers inflation and promotes the emergence of speculative bubbles. Indeed, this can now be seen in the Chinese real estate market.

By allowing the yuan to appreciate, China would benefit from the adjustments that would ensue: interest rates would rise, leading to a decline in consumption ▼

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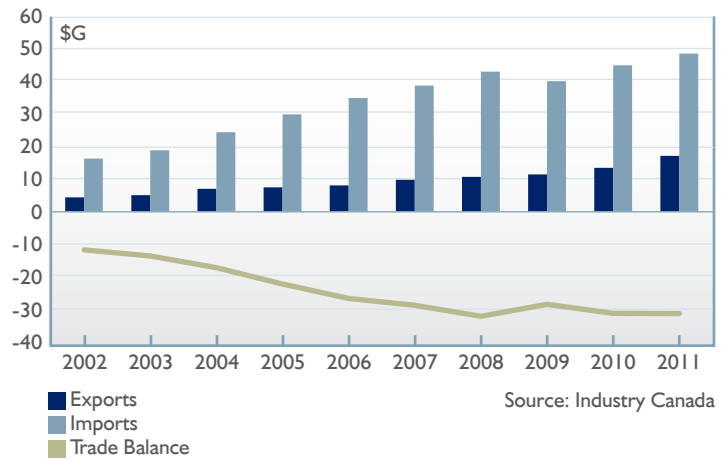
and investment, which would result, in the longer term, in a restoration of balance in the real estate market and a downturn in inflation.

At the same time, China needs to move from an export-based economy to one supported more by domestic demand, which would be far less vulnerable to external shocks. This transition goes hand in hand with a shift to a floating exchange rate regime, which would pull Chinese exports back to a more sustainable level, and enable the Chinese to import the foreign products they crave at a better price.

Obviously it is in the interest of western countries, including Canada, for China to adopt a flexible exchange rate. A stronger yuan would make Chinese imports more costly for Canadians and would spur Canadian exports to China, which would have the effect of stimulating the economy and reducing our trade deficit with that country. The graph shows trading trends between Canada and China over the past decade. From 2002 to 2008, imports from China rose by \$26.6 billion, four times more than exports to that country, which expanded by \$6.3 billion during that period. The deficit subsequently stabilized, but it is still substantial. The recent

widening of the yuan's margin of fluctuation offers hope that China will continue to allow its currency to fluctuate more and more freely in the years to come, and end up adopting a floating exchange rate regime, as desired by the majority of its trading partners. ■

Canadian Trade Balance with China



CANADA

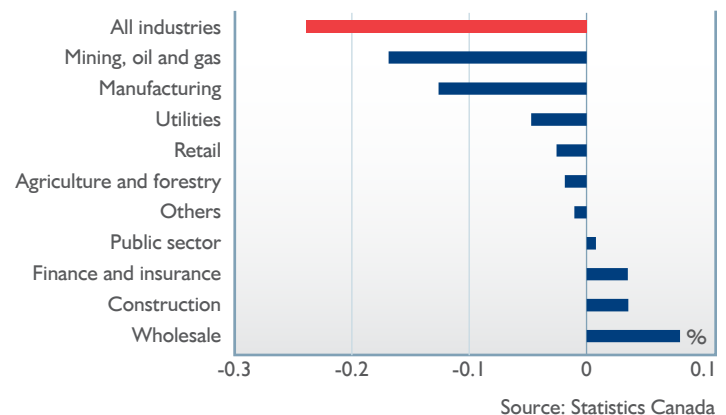
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The real GDP data of the first two months of the year lead us to think that growth will be sluggish in the first quarter. However, escalating job numbers in the past two months leave room for optimism about future quarters. Meanwhile, the housing sector is still firm, no doubt stimulated by the possibility of an interest rate hike, for which the central bank has started to lay the groundwork.

Real GDP pulls back

Real GDP slipped by 0.2% in February after ticking up by just 0.1% in January. The mining, oil and gas extraction sector was affected by temporary mine closures (due to flagging global demand in the case of potash, and for safety reasons in the case of nickel mines); manufacturing posted its first contraction after five straight months of growth; utilities production fell due to the mild weather that curbed demand for electricity and natural gas; retail sales declined, mainly in the automotive sector which had recorded a strong gain in January. On the other hand, the construction, real estate and wholesale sectors advanced. The data suggest that some part of the weakness observed in February is temporary and will be reversed in March; but we should expect weak real GDP growth for the first quarter of 2012.

Main industrial sectors' contribution to the percent change in GDP, February 2012



Employment surges

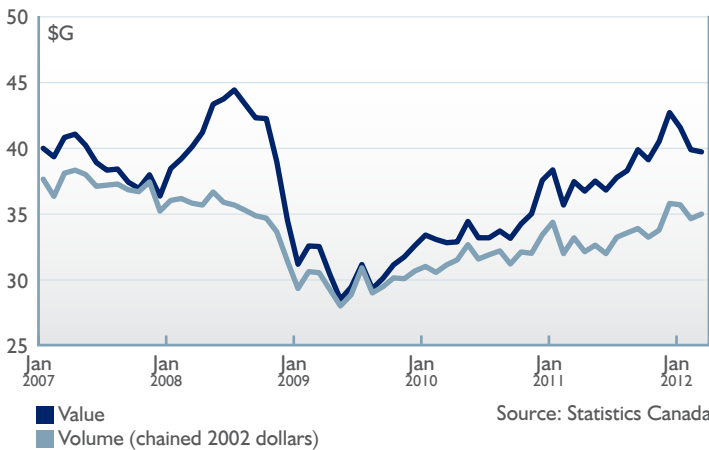
On the heels of a substantial gain of 82,300 in March, employment increased by 58,200 jobs in April. Despite that strong growth, the unemployment rate rose from 7.2% in March to 7.3% in April, due to an expanding labour force. Three quarters of April's increase in employment represented full-time jobs. The construction and manufacturing sectors recorded the greatest gains. From a regional perspective, it was Quebec that saw the highest job growth. This ▼

second straight month of sustained growth has enabled it to make up the severe losses recorded in the last quarter of 2011. The rest of the gains came mainly from British Columbia and Alberta. The latter is the province where job growth has been strongest over the past 12 months (3.9%).

Trade balance improves slightly

The trade balance improved slightly, with the surplus rising from \$273 million in February to \$351 million in March due to the fact that imports dropped more than exports did (-0.6% versus -0.4%). Exports were down for the third month in a row. March's contraction stems mainly from a decline in exports of energy products, whose prices had plummeted compared with the previous month. The decline in imports is also due in large measure to energy products, but in this case it involves a substantial pullback in imported volumes. In real terms, exports grew by 1.0% in March and imports by 0.6%. As shown by the graph, the volume of exports is gradually returning to the level it was at before the recession.

Exports



Housing market still active

Housing starts showed solid growth, rising from 214,800 units in March to 244,900 in April. The increase was concentrated in the multiple-unit sector, which expanded by 27.4% in urban areas, while single-family home starts edged up just 0.6%. From a regional standpoint, activity was particularly lively in Quebec, where housing starts skyrocketed by 56.5% in April, again, mainly in the multiple-unit category. Meanwhile, the resale market is also still highly active. In March, sales of existing homes were up by 2.5% month over month. According to the Canadian Real Estate Association, the resale market is still in a balanced position, but the monthly upturn in sales in March tightened the market slightly. It seems likely that the current low interest rates, and the possibility that they may be raised in the near future, will continue to stimulate the housing market in the months ahead. ■

Housing Starts



★ UNITED STATES

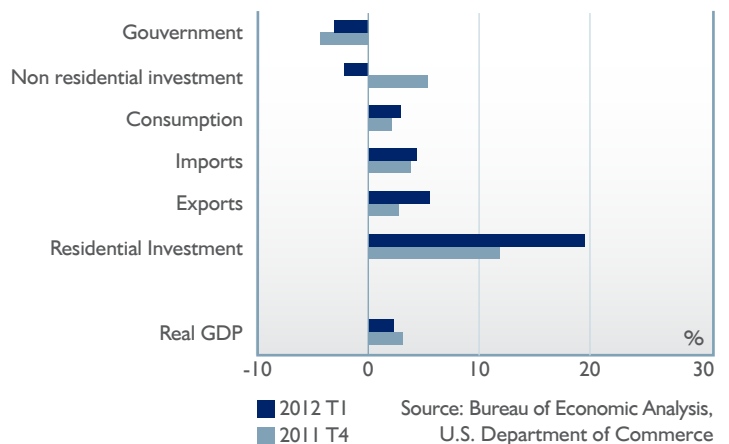
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Real GDP and employment are still advancing, but at a slower pace; the real estate sector has stabilized, but the recovery is still sluggish; manufacturing is getting back on track, as shown by employment growth and business confidence in the manufacturing sector. Overall, these results confirm our expectations of moderate economic growth in 2012.

Real GDP growth slackens

Real GDP growth has slowed, falling from 3.0% in the fourth quarter of 2011 to 2.2% in the first quarter of 2012. Production was mainly supported by consumption, which rose by 2.9% compared with the previous quarter. For the second consecutive quarter, investment in residential construction surged, and growth in exports accelerated (see graph). On the other hand, non residential investment and government spending ▼

Real GDP and related measures: quarterly change (annual rate)

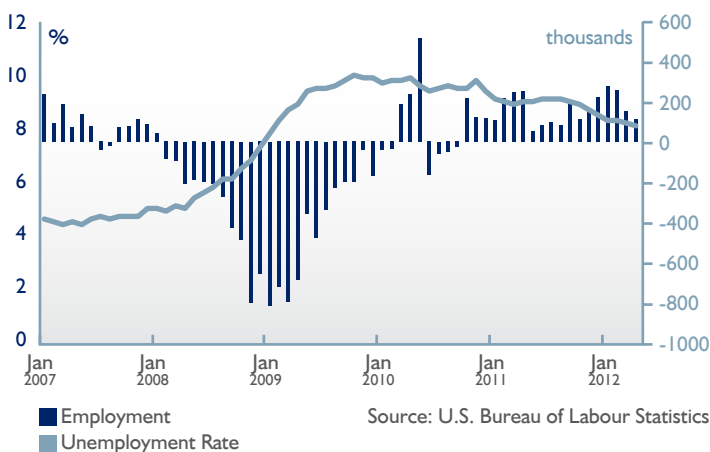


retreated. Imports growth, which makes a negative contribution to GDP growth, was up slightly. This is the first slowdown in the pace of real production growth after three quarters of acceleration. Certainly, 2.2% is not a very robust pace of growth, but it supports expectations of moderate economic growth in 2012.

Job creation loses steam

Job creation has been decelerating in recent months: after an increase of 259,000 in February, employment rose by just 154,000 in March and by 115,000 in April. At the same time, the unemployment rate is declining more slowly, from 8.3% in February to 8.1% in April. Nearly all the major sectors recorded gains in April, including manufacturing, which is still doing well. When the economy is in good shape, over 200,000 jobs can be created in a month (the monthly average was 208,000 in 2005 and 232,000 in 1993, after the 1991-92 recession). Job growth will have to accelerate in the months to come if the United States is to make up the jobs that were lost during the recession.

Monthly Change in Employment and Unemployment Rate



Housing starts and home sales decline

Housing starts tumbled by 5.8% in March compared with the previous month. Starts of single family homes were down by just 0.2%, while those of multiple-unit projects plummeted by 19.8%. Nevertheless, housing starts are now 10.3% higher than they were a year ago, and building permits climbed by 4.5% in March, which bodes well for housing starts in the months ahead. As for existing homes, sales dropped by 2.6% in March. Still, selling prices seem to be stabilizing, and the inventory of existing homes on the market is gradually returning to the average that existed before the crisis (see graph).

Housing Inventory

(month's supply at the current sales pace)



Business confidence improves

The Purchasing Managers' Index compiled by the Institute for Supply Management, which reflects the confidence of manufacturing businesses, gained 1.4 percentage points in April, reaching 54.8%. Of the 18 manufacturing sectors surveyed, 16 reported accelerated growth in April compared with March. The production, new orders and employment indexes all gained ground. The index now stands at a level higher than where it was before the recession. A number above 42.6% over an extended period of time (and this has been the case since May 2009) indicates sustained growth, not only in the manufacturing sector, but in the economy as a whole. ■

INTEREST RATES

The Bank of Canada lays the groundwork for an interest rate hike

On April 17, the Bank of Canada decided to leave its key interest rate unchanged. But in the press release announcing that decision, it laid some groundwork for a hike, stating that "some modest withdrawal of the present considerable

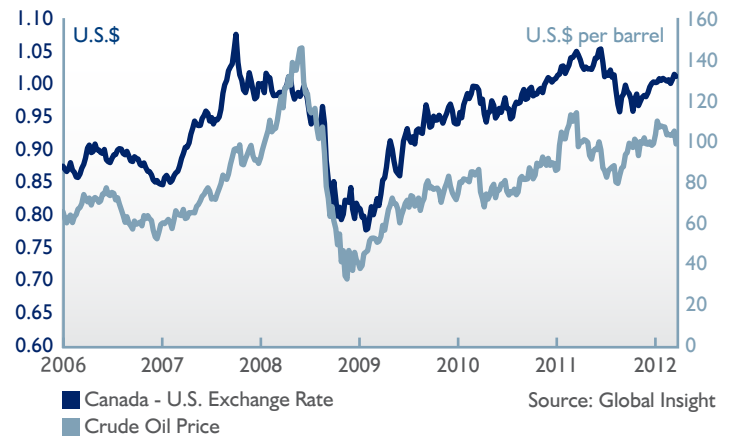
monetary policy stimulus may become appropriate." Despite that statement, the majority of forecasters do not expect the central bank to raise the key interest rate before 2013. They feel that the U.S. economy will need to show greater robustness, and the European situation will have to stabilize, before the Bank of Canada moves forward with this. ■

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The price of oil falls back, the Canadian dollar appreciates slightly

The price of crude oil has fallen back in recent weeks, due to the political uncertainty hanging over Europe, particularly Greece, where the various political parties have not yet managed to form a government. In the recent elections, the parties opposed to greater austerity won a large proportion of the votes, which jeopardizes the continuation of the austerity program ordered by the European Union and the IMF. This uncertainty is weighing heavily on outlooks for European demand for oil. It also encourages investors to turn to safer havens, such as the U.S. dollar, causing it to appreciate. A stronger greenback then makes purchases of commodities (such as oil) that are priced in U.S. dollars, less attractive. Despite the lower price of oil, the Canadian dollar has not only remained stable, but has appreciated slightly. Improvement in economic conditions in the United States, and optimism on the part of the Bank of Canada, which has opened the door a crack to an eventual key interest rate hike, certainly contributed to this state of affairs. ■

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

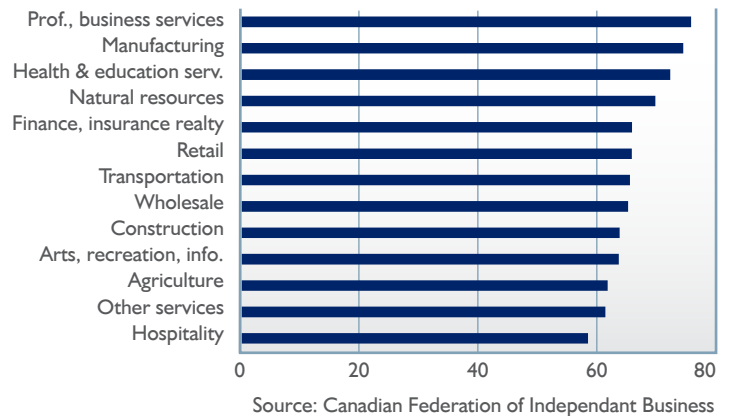


SME CONFIDENCE

SME confidence dips

The CFIB's Business Barometer index slipped by 1.3 percentage points in April, wiping out much of the 1.7-point gain recorded in the previous month. At 66.4%, the index is still relatively high, compared with the results of the past 10 months. Small and medium-sized business owners' outlooks have not changed much since the previous month, and this is true across all regions and all industrial sectors. Generally speaking, confidence is still stronger in Canada's West than in the East, but the gap between the two is small. Among the various sectors, owners in the business services and manufacturing sectors are the most optimistic, while those in the hospitality sector are the least optimistic. ■

CFIB's Business Barometer, april 2012





BUSINESS CREDIT CONDITIONS

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Business credit conditions ease

The Bank of Canada's Business Outlook Survey (BOS) and Senior Loan Officer Survey (SLOS) both show a general easing of credit conditions in the first quarter of 2012. According to the BOS, this easing was evident in most of the regions, sectors, business categories and sources of financing. According to the SLOS, the easing was more substantial for small businesses. Competition between lenders and improvement in economic outlooks are the main reasons put forward to explain this result. ■

Business Credit Conditions
balance of opinions (%)



KEY INDICATORS – CANADA

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Key indicators – Canada	Historical				2011				Latest	Forecasts		
	2007	2008	2009	2010	Q1	Q2	Q3	Q4		2012	2013	
Real GDP (% growth)	2.2	0.7	-2.8	3.2	3.7	-0.6	4.2	1.8	Feb	-0.2	2.1	2.3
Machinery and Equipment Expenditures (% growth)	4.2	-0.5	-19.5	11.8	15.5	30.2	-11.8	2.7			4.7	7.0
Pre-Tax Corporate Profits (% growth)	1.9	11.0	-33.1	21.2	20.7	-5.1	18.3	21.4			8.1	5.7
Industrial Production (% growth)	-0.5	-3.1	-9.5	4.9	6.3	-4.3	7.9	2.5	Feb	-1.4	2.9	3.2
Industrial Product Prices (% growth)	1.5	4.3	-3.5	1.0	9.6	5.4	0.2	0.7	Mar	0.2	2.4	3.0
Non-Residential Construction (% growth)	2.3	7.9	-22.2	2.8	15.9	0.9	17.4	13.3				
Housing Starts (' 000 units)	229	212	148	191	177	192	205	199	Apr	245	186	178
Personal Expenditures (% growth)	4.6	3.0	0.4	3.3	0.6	2.0	1.8	2.9			2.1	2.1
Consumer Price (% growth)	2.1	2.4	0.3	1.8	3.3	3.4	1.0	2.9	Mar	0.4	2.1	2.0
Employment (% growth)	2.4	1.7	-1.6	1.4	2.2	1.6	1.2	-0.3	Apr	0.3		
Unemployment Rate (%)	6.0	6.1	8.3	8.0	7.7	7.5	7.3	7.5	Apr	7.3	7.4	7.2
SMEs Confidence Index (CFIB)	67.2	56.1	57.7	66.7	69.2	68.0	64.2	64.1	Apr	66.4		
Manufacturers Confidence Index (CFIB)	68.8	52.7	56.0	68.6	72.6	71.0	63.5	61.8	Apr	74.5		

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