

economic LETTER

SEPTEMBER 2012



THE EFFECT OF FALLING COMMODITY PRICES ON THE CANADIAN ECONOMY

Over the past 12 months, commodity prices have dropped considerably due to flagging global demand. Many European countries are in recession due to the sovereign debt crisis, which has forced many of them to adopt extremely restrictive budget controls, and the U.S. economy is struggling to make headway. Given that Europe and the United States are important customers for the emerging countries, this has had the effect of curbing the growth of those emerging economies. China, for example, recorded growth of just 7.6% in the second quarter, its lowest result in three years. Admittedly, such growth would be considered extremely robust for an advanced economy, but it is not exceptional for a country with booming demographic growth, like China.

Of all the raw materials, metals especially have shown significant price declines—exceeding 30% in some cases—in the past year (Graph). The price of crude oil has also fallen by around 11% over the past 12 months. For a country like Canada that is an exporter of commodities, these price declines are not without consequences. For one thing, they lead to lower revenues, and for another, they can result in a downturn in investments.

Even though, taken together, mining and oil and gas extraction represent just 4% of Canada's gross domestic product, investment in those sectors now constitutes nearly 20% of the investments in all industries in the country (compared with 10% at the beginning of the 1990s). These sectors are capital-intensive but they do not generate an abundance of direct jobs, since technological advances have led to strong gains in productivity. They do, however, generate many indirect jobs in the service sector.

Natural resource development projects are determined by expectations of returns, which depend on price outlooks; therefore they can be postponed, or even cancelled, if the anticipated price is heading down. That said, commodity prices are cyclical and subject to significant short term fluctuations, while investment projects are based on very long-term projections, as it often takes several years before they become operational. A slump in prices, even if it lasts for some time, does not necessarily compromise such projects. According to forecasters, the downturn in the global economy should be temporary. Once growth firms up in the United States, which is still the largest economy in the ▼

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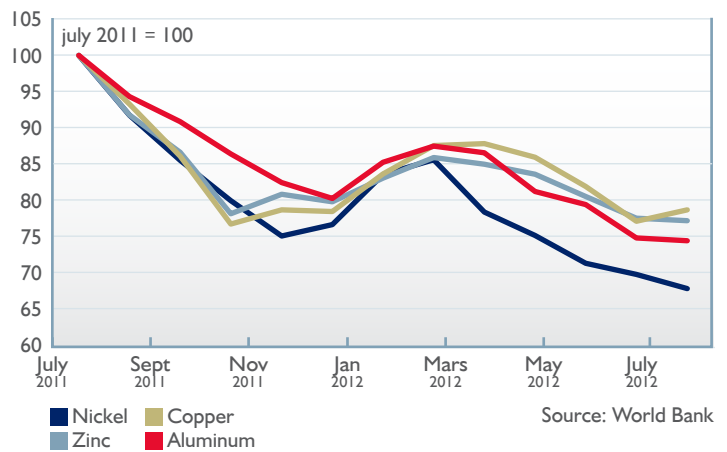
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world in terms of GDP, this should trigger a resurgence of global demand for commodities, and consequently drive their prices up, in the more or less long term.

In the meantime, lower prices are leading, if not to diminishing investments, at least to flagging revenues, both for producers and for governments (through royalties), which translates into a slowdown in economic activity. Forecasts for Canadian economic growth, which currently stand at 2.0% for 2012 according to the Consensus, include the effect of dwindling global demand for commodities. There is no doubt, however, that if the downwards trend in prices intensifies, growth forecasts will be revised downwards once again. ■

Change in selected metal prices over the last 12 months



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The most recent data show that Canadian economic activity is still modest. Growth in the second quarter was mainly supported by business investment, while consumers remained cautious and the government continued to cut spending in an effort to return to a balanced budget. Furthermore, the frailty of the U.S. economy curtailed our exports. These results are in line with forecasters' expectations, which call for 2.0% growth in 2012.

Real GDP growth remains modest

Real GDP expanded by 1.8% in the second quarter of 2012, exactly the same rate of growth as in the first quarter (Graph). Growth in non-residential investment accelerated, thanks to a surge in both investment in construction and investment in machines and materials. On the other hand, growth in residential investment slowed, plunging from 11.5% in the first quarter to 1.8% in the second quarter. Consumer spending rose by 1.1%, while government spending contracted once again, although less severely than in the first quarter. Lastly, exports ticked up by a mere 0.8%, while imports advanced by 6.4%, holding real GDP growth in check. Overall, these results are in line with what forecasters were expecting.

Growth in Real GDP and its components (annualized quarterly change)



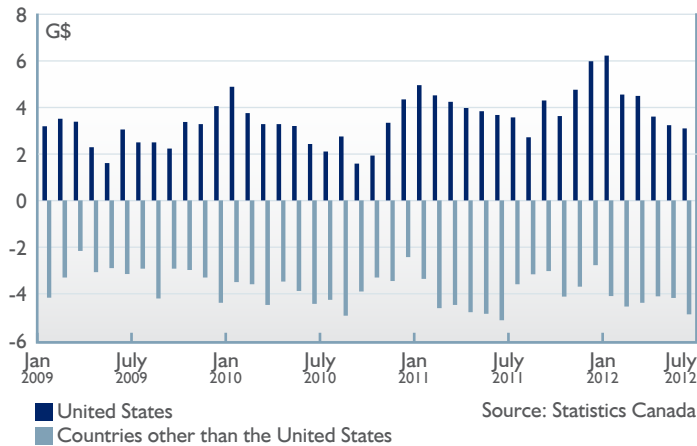
Employment rebounds

After losing 30,400 jobs in July, the labour market rebounded in August with a net gain of 34,300 jobs. The creation of 46,700 part-time jobs was partly cancelled out by the loss of 12,500 full time jobs. The unemployment rate remained stable at 7.3%. The loss of 44,000 jobs in the construction sector was more than offset by gains in many service sectors, including transportation and storage, professional, scientific and technical services, business services and trade. Regionally, it was Quebec that recorded the largest gains, followed by British Columbia, while Ontario suffered the biggest losses. ▼

The trade balance deteriorates

A stronger increase in imports than in exports (2.3% versus 0.2%) caused the trade deficit to expand, from \$954 million in May to \$1.8 billion in June. The machinery and equipment sector led the rise in imports in June, setting a new record. The only sector that posted a decline in imports is energy products. On the exports side, a sharp increase in the automotive products sector served to neutralize the declines reported in five of the seven major sectors. The trade surplus with the United States has gradually shrunk over the past six months, while the deficit with countries other than the United States has remained relatively stable (Graph).

Commercial Balance



Housing starts fall, while sales of existing homes remain stable

The number of housing starts fell from 222,100 units in June to 208,500 in July. In urban centres, starts of single-family homes slid by 4.0% in July and those of multiple-unit projects by 7.6%. The CMHC anticipates that the average number of housing starts in 2012 will be 202,700 units. If those forecasts materialize, we will see further declines in the coming months. As for sales of existing homes, they remained stable from June to July. The ratio of sales over new listings, which is used to measure how balanced the market is, stood at 53.4% in July 2012, compared with 51.6% in June. According to the Canadian Real Estate Association, the national housing market is resting securely in a balanced position.

Industry profit outlooks are down

The Leading Indicator of Industry Profitability (LIIP) recorded a third straight drop in July. The inability of European countries to resolve the sovereign debt crisis is casting a great deal of uncertainty over global economic outlooks, and this is driving the price of crude oil down. This is reflected in the oil extraction index, which in July posted its biggest plunge in three years and the sharpest drop of the 49 sectors covered by the LIIP. On the other hand, profit outlooks are good in most of the manufacturing industries and in all the services, except for telecommunications, which is probably affected by flagging consumer confidence. ■

★ UNITED STATES

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The U.S. economy is growing at a very sluggish pace. Employment is expanding, but slowly. The housing market is gaining ground, but at a snail's pace. The manufacturing sector, which had been making good progress since the end of the recession, has lost steam in the past three months. Forecasters are anticipating 2.2% growth in 2012, which means that the second half of the year is likely to be as gloomy as the first.

Real GDP advances slightly

After a 2.0% rise in the first quarter, real GDP advanced by 1.7% in the second quarter of 2012. All the components, except for exports, saw their rate of growth diminish in the second quarter compared with the previous one (Graph). Government spending was down for the eighth quarter in a row. According to the most recent Consensus, American real GDP should grow by 2.2% in 2012 and by 2.1% in 2013. ▼

Growth in Real GDP and its components (annualized quarterly change)



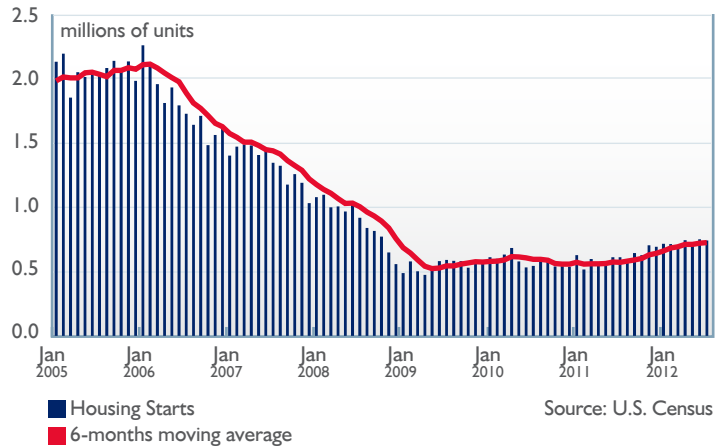
Employment growth slows

The labour market expanded by 96,000 jobs in August after a gain of 141,000 jobs in the previous month. The unemployment rate fell slightly, dipping from 8.3% in July to 8.1% in August. Job creation is still anemic in the construction sector, while manufacturing recorded its first pullback since September 2011. Labour market activity is struggling to get back on track. Job creation has tapered off considerably: an average of 96,000 jobs were created in the past six months, compared with an average of 195,000 in the six months before that. More than two years after the end of the recession, only about half of the jobs lost have been recovered.

Stagnation in the housing market

The number of housing starts dipped from 754,000 units in June to 746,000 units in July, a monthly drop of 1.1%. Housing starts were down by 6.5% in the single-family home segment, but up by 9.6% in the multiple-unit segment. The recovery in housing starts is still exceedingly slow, despite the current low interest rates (Graph). Meanwhile, sales of existing homes were up by 2.3% in July compared with the previous month. The resale market is also gaining ground slowly: at the current pace of sales, it would take 6.4 months to sell off the existing inventory of homes on the market, whereas a normal figure would be in the neighbourhood of 5 months.

Housing Starts (January 2005 to July 2012)



Confidence ebbs in the manufacturing sector

The Institute for Supply Management's Purchasing Managers' Index for the manufacturing sector, which measures business confidence in that sector, remained below the 50% mark in August for the third straight month. Standing at 49.6%, the index signifies contraction in the manufacturing sector, although it still indicates expansion in the overall economy (this is what is meant by an index above 42.6% for several months). The production sub-index fell below the 50% threshold for the first time since May 2009. In short, the ISM data do not bode very well for manufacturing activity in the months ahead. ■

INTEREST RATES

The key interest rate will not rise for several months to come

The Bank of Canada left its benchmark interest rate unchanged at 1.0%. The central bank considers that the global economy is unfolding as it had expected: activity is expanding gradually in the United States, the European crisis is not resolved, but it is contained, and China's economic growth is decelerating.

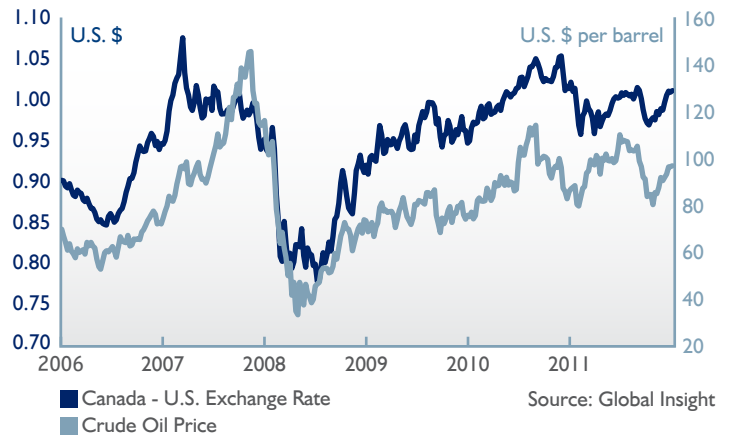
In Canada, economic activity is sluggish, but it should accelerate in 2013. Surplus capacity still exists, but if it continues to be absorbed, the central bank warns us that it will have to raise the key interest rate to keep inflation in check. Given the current state of the economy, the vast majority of forecasters believe that this will not happen for several months to come. ■

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The price of oil climbs and the Canadian dollar appreciates

The price of crude oil resumed an upwards trend in August, reaching its highest level since mid May. Many events contributed to this rally: the resurgence of tensions in the Middle East, in particular, fears that Israel might declare war on Iran and the possibility that Iran might react by closing the Strait of Hormuz; the depreciation of the U.S. dollar, which made the price of oil more affordable and stimulated demand; a wave of optimism about the resolution of problems in Europe; more recently, fears that tropical storm Isaac might damage oil facilities in the Gulf of Mexico, which account for 23% of American crude oil production and nearly half the refining capacity in the United States; and, lastly, hope that the Chinese and American central banks would take steps to stimulate their respective economies. However, the price of crude oil has slipped in the past week, after the release of the ISM index which revived concerns about economic growth in the U.S. The Canadian dollar appreciated in tandem with the increase in the price of crude oil. ■

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

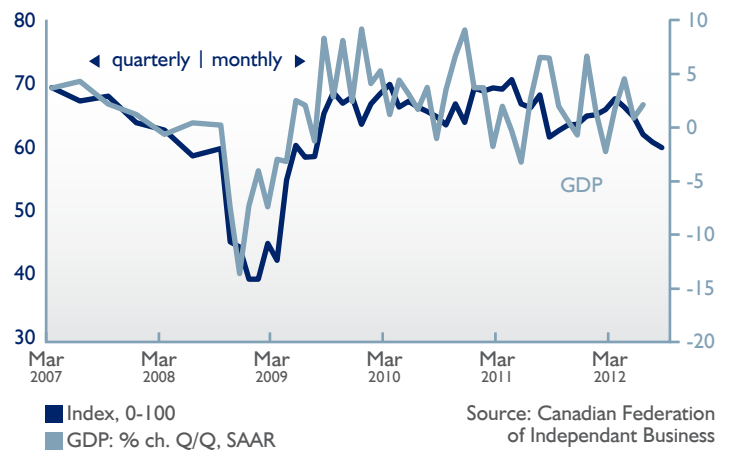


SME CONFIDENCE

SME confidence loses more ground

The Canadian Federation of Independent Business's Business Barometer Index lost ground for the fifth straight month. It has gradually slid from a peak of 67.7 in March to reach 60.0 in August. Nevertheless, the index is still 20 points higher than the nadir of 39.4 that was recorded during the recession (Graph). If we look at the regions, we note the plunge by the Prince Edward Island index which, at 44.9, now stands at its lowest level since March 2009. This is probably due to the extremely hot and dry weather that the province experienced this summer, which is likely to have a negative impact on the potato harvest. In fact, the agriculture sub-index is the weakest, after the transportation sub-index. The SME owners in the oil-producing provinces, i.e. Newfoundland-and-Labrador, Alberta and Saskatchewan, are still the most optimistic in the country. ■

CFIB Business Barometer and Real GDP Growth
(Index of 50 = equal balance of stronger and weaker business expectations)





BUSINESS CREDIT CONDITIONS

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Business credit growth remains strong

Short-term credit granted to businesses by the chartered banks expanded by 26% in July compared with the previous month, while long-term credit contracted by 4.7%. From July 2011 to July 2012, annual growth in total credit to businesses granted by the chartered banks has remained stable, at around 8.5% (Graph). ■

Business Credit from Chartered Banks
(12-month change, January 2005 to July 2012)



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			Jun	0.2	2.0	2.1
Machinery and Equipment Expenditures (% growth)	-0.5	-19.5	11.8	12.5	4.0	7.2					2.8	6.3
Pre-Tax Corporate Profits (% growth)	11.0	-33.1	21.2	15.4	-14.0	-17.5					3.4	4.4
Industrial Production (% growth)	-3.1	-9.5	4.9	3.5	-1.2	2.5			Jun	0.3	1.9	2.8
Industrial Product Prices (% growth)	4.3	-3.5	1.0	4.6	0.9	0.5			Jul	-0.5	1.1	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			Jul	209	203	180
Personal Expenditures (% growth)	3.0	0.4	3.3	2.4	0.7	1.1					1.9	2.1
Consumer Price (% growth)	2.4	0.3	1.8	2.9	2.1	0.1			Jul	-0.1	1.9	2.0
Employment (% growth)	1.7	-1.6	1.4	1.5	0.9	2.8			Aug	0.2		
Unemployment Rate (%)	6.1	8.3	8.0	7.5	7.4	7.3			Aug	7.3	7.3	7.2
SMEs Confidence Index (CFIB)	56.1	57.7	66.7	66.4	66.3	64.4			Aug	60.0		
Manufacturers Confidence Index (CFIB)	52.7	56.0	68.6	67.2	69.0	67.2			Aug	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.