

economic LETTER

JANUARY 2013



2013: PEEKING INTO THE CRYSTAL BALL

At the beginning of last year, the Consensus (an organization that compiles economic and financial forecasts for twenty-odd countries) announced that in 2012, real GDP growth would reach 2.0% in Canada and 2.2% in the United States. We do not yet have the national accounts data for the last quarter of the year, but based on the most recent estimates, it would seem that that is exactly what will happen.

According to the Consensus, economic growth will slow to 1.9% in the United States in 2013. Forecasters anticipate that growth in consumption will be moderate, as it was in 2012, and that housing starts will gradually pick up steam, but they predict that growth in non-residential investments by private businesses will be slower than last year. Foreign trade will again make a modest contribution to growth, while that of government spending will remain negative, since the authorities need to put public finances in order. Employment will keep advancing, but slowly, so the unemployment rate will remain high.¹

Under these conditions, interest rates will remain low in the United States for a long time to come. In fact, in its most recent press release, the Federal Reserve announced that it would keep its benchmark interest rate at its current range of 0 to 0.25% for as long as the unemployment rate stayed above 6.5%, provided that inflation between one and a half and two years ahead was projected to be no more than 2.5% and that longer-term inflation expectations continued to be well anchored. The Federal Reserve has a two-fold mandate: controlling inflation and promoting employment. But it had never specified an unemployment target before; this is a first. No doubt the central bank issued this statement with the goal of reassuring the financial markets of its determination to do everything in its power to ensure that economic growth would return to a faster cruising speed. Since the Federal Reserve does not expect the unemployment rate to fall back below 6.5% until 2015, this means that it intends to leave the benchmark interest rate where it is until then, if inflation stays under control.

Canadian economic growth rarely strays very far from that of the United States, although this does happen occasionally. As shown by the graph below, the United States fell into recession before we did, their recovery in 2010 was not as strong as ours, and they recorded less growth in 2011. The financial crisis hit them far ▼

¹ It is important to note that the forecasters were anticipating that the Democrats and Republicans would reach an agreement in order for the country to avoid the fiscal cliff that it was facing; this was indeed achieved... in extremis: a new bill that approved tax hikes for the richest households and spared the middle class was approved on January 1.

Canada

- > Real GDP expands slightly
- > A strong advance in employment
- > The trade deficit shrinks
- > Housing starts fall again

United States

- > Employment continues its upwards trend
- > Housing starts slump, but home sales keep increasing
- > Business owners and consumers are worried about the fiscal cliff

Interest rates

The key interest rate will stay where it is for months to come

Oil and dollar

SME confidence

Credit conditions

Key indicators

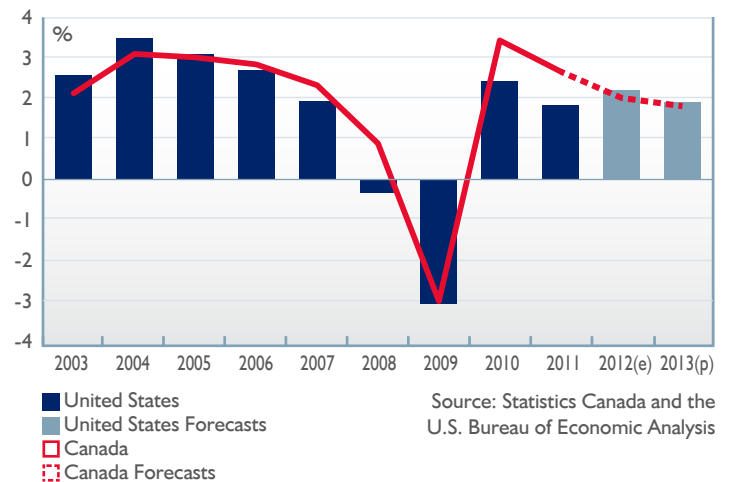
BDC's Monthly Economic Letter is prepared by the Economic Analysis team from Marketing and Public Affairs and is based on a variety of public sources of economic data. The information in this letter is drawn from data released prior to January 10. Reliance on and use of this information is the reader's responsibility.

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harder than it did us; but given the close trade ties that bind us to them, our economic growth cannot diverge from theirs for very long. For 2013, the Consensus is calling for real GDP growth of 1.8% in Canada. Forecasters are expecting growth in consumption and in non-residential investment to accelerate. Housing starts should pull back, however. The Canada Mortgage and Housing Corporation is predicting a drop in multiple-unit starts, since pre-sales were lower in 2012 than those observed at the end of 2010 and 2011; meanwhile, starts of single-family homes should remain stable. Government spending will likely decline, in order to achieve a return to a balanced budget. Lastly, the contribution by net exports to growth should be limited, due to the lacklustre growth of the American economy.

Both in Canada and in the United States, forecasters anticipate that real GDP growth will gradually pick up steam from one quarter to the next during the year, and will be stronger in 2014, reaching 2.5% in Canada and 3.0% in the United States. ■

Real GDP in Canada and in the United States
(2003 to 2013)



CANADA

[Back](#)

The most recent indicators, particularly the strong advance in employment in December, give hope that real GDP growth accelerated in the fourth quarter of 2012. As far as construction is concerned, in the past few months we have observed the slowdown in housing starts that the Canada Mortgage and Housing Corporation had predicted at the beginning of 2012.

Real GDP expands slightly

The fourth quarter of 2012 started off with limp real GDP growth: 0.1% in October, after a static reading in September. Wholesale trade, which had lost quite a bit of ground in the previous month, rallied in October. Retail trade also advanced, as did mining and gas and oil extraction. On the other hand, production pulled back in manufacturing, construction, transportation and warehousing, as well as in the arts and entertainment sector which suffered from the labour dispute in professional hockey.

A strong advance in employment

In December, full-time employment expanded by 41,200 jobs, while part-time employment contracted by 1,400 jobs, for net job creation of 39,800. The unemployment rate fell to 7.1%, its lowest level since December 2008 (Graph). It was Ontario that recorded the largest gains in December (32,900), but these were mainly in part-time work (26,500). The economic sectors that saw the strongest employment growth were transportation and warehousing (21,500) and construction (17,800), while professional, scientific and technical services suffered the biggest losses (41,500).

Unemployment Rate
(Decembre 2006 to Decembre 2012)



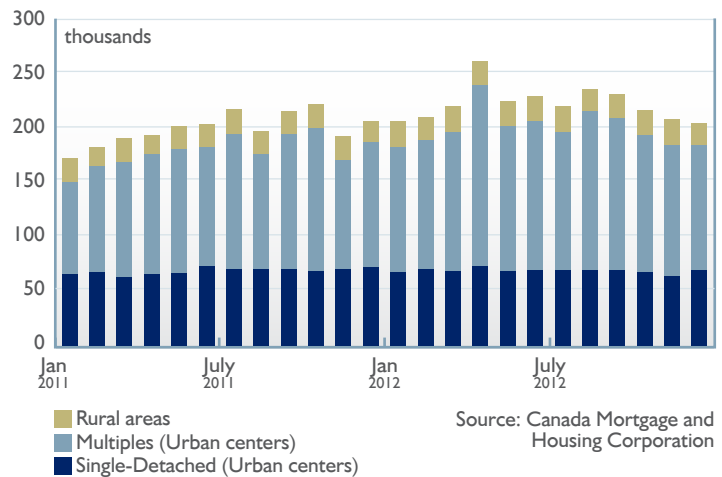
The trade deficit shrinks

A decline in imports (-1.2%), combined with an increase in exports (1.0%), produced a reduction in the trade deficit, which went from \$1.0 billion in September to \$169 million in October. This is the third straight decrease in the trade deficit. Imports declined in the bulk of the major sectors, but the basic and industrial chemical, plastic and rubber products sector recorded the largest drop. On the exports side of the equation, it was farm, fishing and intermediate food products that saw the strongest gains. ▼

Housing starts fall again

The number of housing starts fell for the fifth month in a row, from 201,376 units in November to 197,976 units in December. In urban centres, starts of single-family homes increased by 8.6%, while those of multiple units were down by 4.7%. In rural areas, they dropped by 14.3%. The Canada Mortgage and Housing Corporation anticipates 193,600 housing starts in 2013. They will remain stable in the single-family segment, but will pull back in the multiple-unit segment. ■

Housing Starts (January 2011 to December 2012)



★ UNITED STATES

[Back](#)

The economy is gradually gaining strength, but there is a tough road ahead, as may be seen from the slow growth in employment and the erratic performance by housing starts. The budget agreement that was reached by the Democrats and Republicans at the beginning of the year should restore business and consumer confidence.

Employment continues its upwards trend

Employment continued its upwards trend in December with a gain of 155,000 jobs. In 2012, an average of 153,000 jobs were created per month, just as in 2011. By December, slightly more than half of the jobs that were lost during the recession

Discouraged Workers



had been recovered. If employment growth continues at this pace, it will take approximately two more years before employment returns to where it stood prior to the recession. The unemployment rate came in at 7.8% in December, which is the point around which it has been fluctuating since September. It is worth noting that this rate does not take into account the “discouraged workers,” i.e. people who have stopped looking for work because they are convinced, for various reasons, that they will not find any. The number of discouraged workers is still very high compared with pre-recession levels (Graph). In short, the job market is recovering, but it is far from regaining its former strength.

Housing starts slump, but home sales keep increasing

Housing starts were down by 3.0% in November compared with the previous month. The decline is entirely attributable to the single-family segment, where starts fell by 4.1%, while starts of multiple-unit projects rose by 1.4%. Year over year, housing starts were up by 21.6% in November. In the real estate sector, the upwards trend is continuing: home sales advanced by 5.9% in November compared with October. At the current pace of sales, it would take 4.8 months to sell off the current inventory of homes on the market. This is the lowest inventory recorded since September 2005, when it stood at 4.6 months (Graph). This is good news and gives us reason to believe that the real estate market is improving in a sustainable way. ▼

Housing Inventory

(month's supply at the current sales pace)



Source: U.S. National Association of Realtors

Business owners and consumers are worried about the fiscal cliff

After dropping below the 50% mark in November, the Institute for Supply Management's Purchasing Managers' Index edged up to 50.7% in December. The confidence of manufacturing business owners is still lukewarm, however. The conflict between the Democrats and the Republicans over the budget, which had yet to be resolved in December, had a negative impact on many business owners. Consumer confidence was also shaken by fears of the fiscal cliff, which was liable to plunge the United States into recession: the Consumer Confidence Index, compiled by the Conference Board, lost a good deal of ground, falling from 71.5% in November to 65.1% in December. ■

INTEREST RATES

[Back](#)

The key interest rate will stay where it is for months to come

No one expects the Bank of Canada to raise its key interest rate on its next rate-setting date, January 23. Indeed, the vast majority of economists do not anticipate an increase in the key rate before the last quarter of 2013, and some foresee no change before the second quarter of 2014. In the United States, the Federal Reserve has announced that it will leave

the benchmark interest rate unchanged for as long as the unemployment rate stays above 6.5%, provided that inflation and long-term expectations of inflation are under control. According to the American central bank's own forecasts, the unemployment rate will not drop below 6.5% before 2015. This means that the benchmark interest rate, which has been fixed at the range of 0 to 0.25% since the end of 2008, will remain low and stable for a long time to come. ■

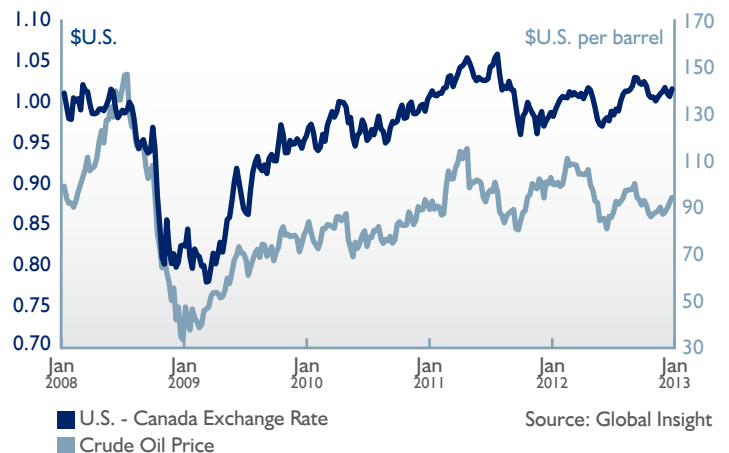
OIL AND THE LOONIE

[Back](#)

The price of oil increases, the Canadian dollar remains stable

The price of a barrel of crude oil has gone up, as the budget agreement in the United States pushed prices up at the start of the year. But the fragility of the European economy, along with persistent tensions in the Middle East, has held that increase in check. As for the Canadian dollar, it has remained fairly stable in recent weeks, close to parity with the U.S. dollar. ■

Price of Oil and the Canada - U.S. Exchange Rate

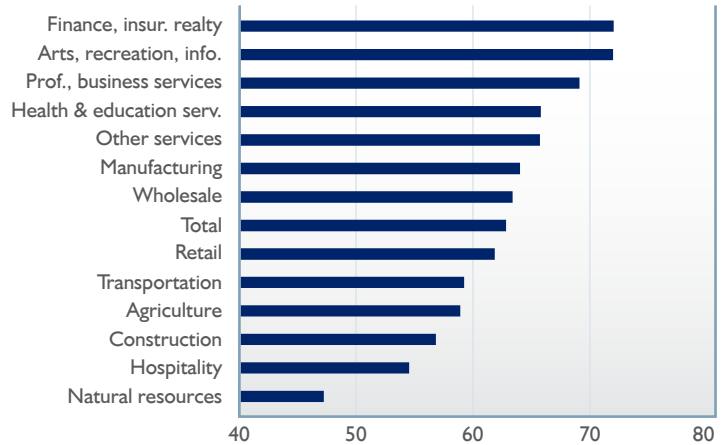


Source: Global Insight

Business confidence stabilizes

The Canadian Federation of Independent Business's Business Barometer Index remained nearly static, slipping from 62.9 in November to 62.6 in December. Business leaders in Newfoundland and Labrador and in the western provinces are still the most optimistic in the country, but less so than in previous months. Conversely, business leaders in the eastern and central parts of the country are more optimistic than they were before, so the regional gaps have narrowed. The natural resources sector is lagging behind, with an index of just 47.1, which partly accounts for the decline in confidence in the western provinces and Newfoundland. At the other end of the spectrum, the finance, insurance and realty sector, and that of arts, entertainment and information, are leading the race, with indexes above 70 (Graph). ■

Business Barometer, by industry
(Decembre 2012)



Source: Canadian Federation of Independent Business

BUSINESS CREDIT CONDITIONS

Bank credit to businesses accelerates

Short-term credit granted to businesses by the chartered banks climbed by 9.7% from October to November, while long-term credit rose by 9.5%. Annual growth in total bank credit granted to businesses continued its upwards trend, reaching 12.1% in November (Graph). ■

Business Credit from Chartered Banks
(Annual Change from November 2006 to November 2012)



Source: Bank of Canada

| Key indicators – Canada | Historical | | | | 2012 | | | | Latest | Forecasts | | |
|---|------------|-------|------|------|-------|-------|------|------|--------|-----------|------|-----|
| | 2008 | 2009 | 2010 | 2011 | Q1 | Q2 | Q3 | Q4 | | 2012 | 2013 | |
| Real GDP (% growth) | 1.1 | -2.8 | 3.2 | 2.6 | 1.7 | 1.7 | 0.6 | | Oct | 0.1 | 2.0 | 1.8 |
| Machinery and Equipment Expenditures (% growth) | 0.1 | -20.4 | 13.7 | 10.7 | 4.1 | 1.6 | 0.2 | | | | 3.3 | 5.2 |
| Pre-Tax Corporate Profits (% growth) | 11.0 | -33.1 | 21.2 | 15.4 | -23.7 | -17.2 | 4.4 | | | | -1.0 | 3.0 |
| Industrial Production (% growth) | -3.1 | -9.5 | 4.9 | 3.5 | -1.5 | 1.0 | -2.5 | | Oct | 0.1 | 0.8 | 1.8 |
| Industrial Product Prices (% growth) | 4.3 | -3.5 | 1.0 | 4.6 | 0.9 | 0.9 | -2.5 | | Nov | -0.3 | 0.6 | 1.3 |
| Non-Residential Construction (% growth) | 7.8 | -18.6 | 15.0 | 10.2 | 9.0 | 14.2 | -4.4 | | | | | |
| Housing Starts (' 000 units) | 211 | 148 | 191 | 193 | 206 | 231 | 222 | | Dec | 198 | 213 | 183 |
| Personal Expenditures (% growth) | 2.9 | 0.1 | 3.5 | 2.4 | 1.1 | 0.4 | 3.1 | | | | 1.9 | 2.1 |
| Consumer Price (% growth) | 2.4 | 0.3 | 1.8 | 2.9 | 2.1 | 0.1 | 0.1 | | Nov | -0.2 | 1.6 | 1.8 |
| Employment (% growth) | 1.7 | -1.6 | 1.4 | 1.5 | 0.9 | 2.8 | 0.4 | 2.3 | Dec | 0.2 | | |
| Unemployment Rate (%) | 6.1 | 8.3 | 8.0 | 7.5 | 7.4 | 7.3 | 7.3 | 7.2 | Dec | 7.1 | 7.3 | 7.3 |
| SMEs Confidence Index (CFIB) | 56.1 | 57.7 | 66.7 | 66.4 | 66.3 | 64.4 | 61.0 | 63.7 | Dec | 62.6 | | |
| Manufacturers Confidence Index (CFIB) | 52.7 | 56.0 | 68.6 | 67.2 | 69.0 | 67.2 | 65.3 | 65.2 | Dec | 63.8 | | |

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