

economic LETTER

JUNE 2013



THE HOUSING MARKET: LESS FLOURISHING, BUT ALSO LESS WORRISOME

A little less than a year ago, the monthly economic letter's topic of the hour was the housing sector.¹ At that time, the homebuilding sector and the real estate market (especially the multiple-unit segment) were ebullient. Some observers were convinced that we were facing a real estate bubble, while others felt that the housing market was supported by fundamental economic factors and that if there was a bubble, it was limited to the condo markets in a few major urban centres.

Since then, the housing market has cooled significantly. Sales in the residential real estate market have lost ground, and housing starts have done likewise, especially in the multiple-dwelling segment (Graph 1). Prices are holding firm, but their growth has definitely slowed, as shown by the MLS home price index compiled by the Canadian Real Estate Association,² and analysts are anticipating that flagging demand combined with excessive supply—particularly in the condo segment—will soon drive prices down. In fact, this has been happening in Vancouver over the past several months.

The tightening of mortgage lending rules, in July 2012, has a lot to do with this state of affairs. The new rules, particularly the shortening of the maximum amortization period for purchases with a down payment of less than 20%, from 30 years to 25 years, have cooled the enthusiasm of first-time homebuyers especially. The increase in monthly mortgage payments stemming from this measure is large enough to delay home ownership, or call it into question, for households that are not rolling in money. This also explains the more significant slowdown in activity in the condo sector, since condos are more accessible to first-time buyers than single-family homes.

The new regulations have thus proven effective and have counterbalanced the stimulating effect that mortgage interest rates, currently at historic lows, are having on the housing market. The risk of a severe correction in certain markets—particularly in the condo sector in Vancouver, Toronto and Montreal—still exists, but has abated considerably. The majority of analysts are now expecting a soft landing by the Canadian housing market. ▼

¹ Business Development Bank of Canada, Is Canada experiencing a housing bubble, or just a balloon?, Monthly economic letter, July-August 2012.

² The MLS home price index data are available on the Canadian Real Estate Association's website, at: <http://www.crea.ca/canadian-home-sales-rise-april>

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- > Employment advances strongly
- > The balance of trade deteriorates somewhat
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United States

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- > Business confidence slips, while consumer confidence improves

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The key interest rate holds steady at 1.0%

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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 June 8. Reliance on and use of this information is the reader's responsibility.

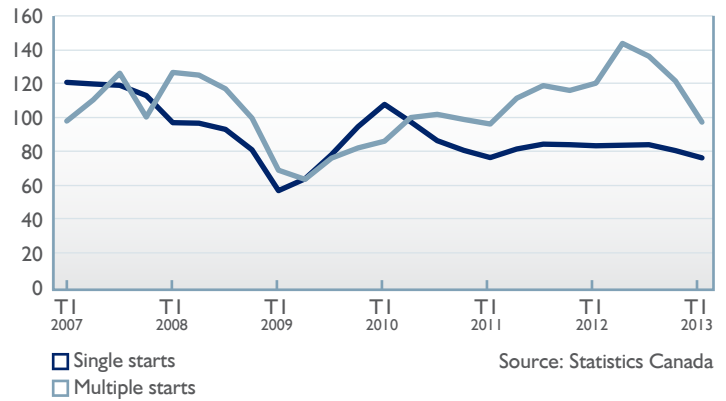
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While no collapse is in sight for the housing market, the slowdown in activity in that sector will nevertheless have repercussions on Canada's economic growth. In recent years, homebuilding has captured a greater share of GDP (Graph 2). In 2012, that share was around 7%. We should expect this to fall back towards its long-term average, which is 5.7%. The Bank of Canada predicts that the contribution of homebuilding investment to annual GDP growth will be negative in 2013 and 2014, and zero in 2015.

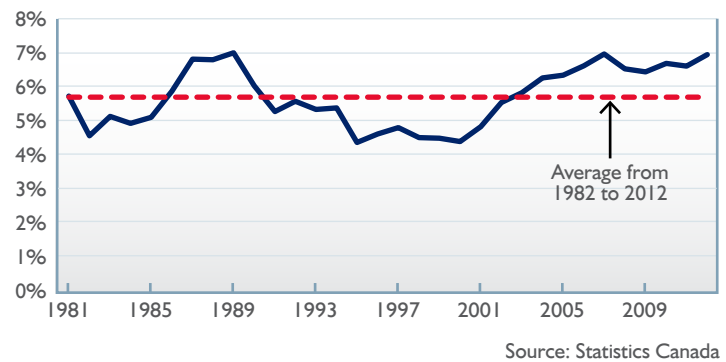
Other components of GDP will also suffer consequences from the slowdown in the housing market: realty services, naturally, but also consumer spending on durable goods. The growth of such spending correlates with that of homebuilding investment, since households that purchase a home usually acquire furniture and domestic appliances at the same time.

In short, the cooling of the real estate market will hold economic growth in check in the years ahead. Rather than complain about it, we should be pleased to have avoided the creation of a bubble, and the consequences of its bursting, which would have been far more serious. We need only take a look at what has happened to the American housing market, which is barely starting to recover, to convince ourselves of that. In the end, as the saying goes, an ounce of prevention is worth a pound of cure. ■

Graph 1 : Housing Starts
(2007 Q1 to 2013 Q1, thousands of units)



Graph 2 : Share of Residential Investment in GDP
(1981 to 2012)



CANADA

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Real GDP growth accelerated in the first quarter of the year, but this is entirely attributable to foreign trade. Domestic demand is flagging, hence the decline in business confidence. On the other hand, the labour market situation showed definite improvement in May, giving hope that domestic demand may firm up in the upcoming quarters.

Real GDP growth accelerates

Real GDP growth accelerated in the first quarter of 2013 compared with the previous quarter, climbing from 0.9% to 2.5%. This is entirely due to strong growth in exports—mainly of energy products, metal products, non-metallic mineral products and consumer goods—as all of the other main components of real GDP posted weaker growth than in the previous quarter. Consequently, final domestic demand grew by a mere 0.6%, its weakest quarterly growth since the recession of 2009 (Graph). Homebuilding investment recorded its third straight drop (-4.7%). Private business ▼

GDP and final domestic demand
chained (2007) dollars, quarterly change at annual rate (%)



investment in plant and equipment and government expenditures also fell from the previous quarter, by 0.7% and 2.0% respectively. Consumer spending ticked up by 1.1%, compared with 2.2% in the fourth quarter of 2012. Lastly, imports rose by 1.2%, after a 3.1% decline in the previous quarter.

Employment advances strongly

After a roller-coaster start to the year, employment recorded an extraordinary gain of 95,000 jobs in May, 76,700 of them being full-time jobs and 18,200 part-time. Such considerable monthly variation had not been seen since August 2002. The unemployment rate fell back slightly, from 7.2% in April to 7.1% in May. The greatest gains were achieved in construction and commerce, while manufacturing and professional, technical and scientific services suffered the greatest job losses. Looking at the regions, Ontario won the lion's share of the spoils, with a gain of 50,600 jobs. Thanks to the strong growth reported in May, employment in Canada is up by 81,800 jobs since the beginning of the year, which is actually a rather modest gain. By comparison, in May 2012, employment had expanded by 141,900 jobs since the start of the year.

The balance of trade deteriorates somewhat

Imports rose by 1.2% in April, compared with the previous month, and exports slipped by 0.2%. Consequently, the trade balance deteriorated from a \$3 million deficit in March to a \$567 million deficit in April. The decrease in exports is due to lower prices, as volumes expanded by 0.5%; meanwhile, the increase in imports is entirely due to greater volumes. The trade surplus with the United States ticked up from \$3.8 to \$3.9 billion, while the deficit with countries other than the United States expanded from \$3.8 to \$4.4 billion. Overall, the trade balance has remained fairly stable since the beginning of the year (Graph).

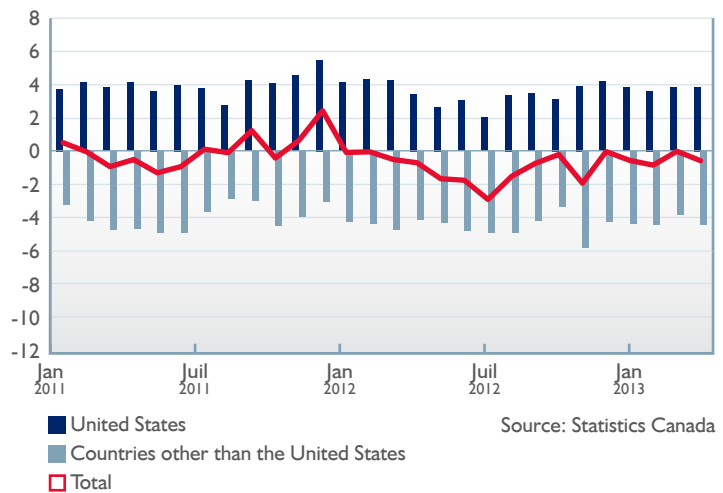
★ UNITED STATES

The job market is recovering, but the unemployment rate is still high. The housing market seems to be picking up steam, especially on the resale side, but it is not back to normal yet. Consumer confidence is improving, but business confidence is down. In short, the American economy is heading upwards, but progress is slow.

Employment continues to rise

Employment expanded by 175,000 jobs in May and the unemployment rate ticked up by one tenth of a percentage point, reaching 7.6%. Since the beginning of the year, employment has grown by an average of 189,000 jobs per month, compared with a monthly average of 183,000 in 2012. Employment is nearly back to where it was before the recession, but at the same time, the unemployment rate is still much higher (Graph). Moreover, the numbers of discouraged ▼

Canada International Trade Balance (January 2011- April 2013, billions of dollars)

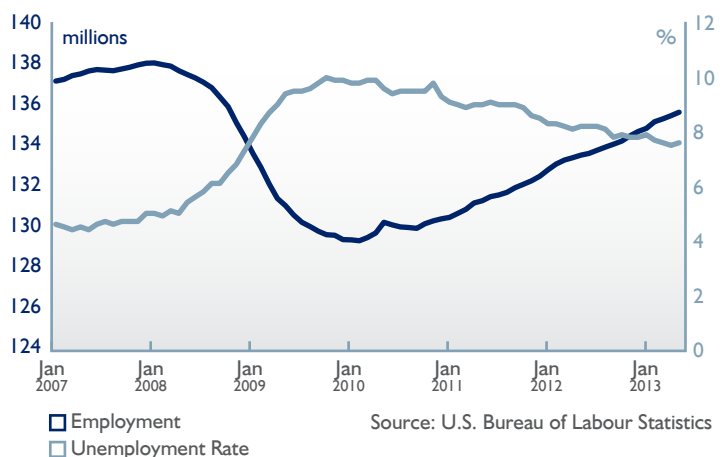


Economic outlooks are favourable

The Macdonald-Laurier Institute's composite leading index advanced by 0.2% in April after a gain of the same size in the previous month. This growth is partly attributable to that of the leading indicator for the United States, which has maintained a faster rate of growth than the Canadian index since the beginning of the year. Housing proved to be the weakest component of the index, pulling back by 0.9%, mainly due to a decline in housing starts. According to the index's designer, the composite leading indicator suggests that Canada's economy will keep recovering between now and the end of the year. ■

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Employment and Unemployment Rate (January 2007 to May 2013)



workers (those who have withdrawn from the labour force because they are convinced they will not find a job) and of people who are working part-time for economic reasons (because they are unable to find full-time work, or their employer has reduced their work hours) are still high. In short, the job market is improving, but is far from being back to normal.

Housing starts tumble, but sales of existing homes edge up

After two monthly gains in a row, housing starts tumbled by 16.5% in April. Starts of single-family homes dipped by 2.1%, while starts of multiple-unit homes plunged by 37.8%. Given the volatility of these data, especially starts of multiple-unit homes, it is advisable to analyze them over a horizon of several months. If we do that, we note a pause in the upwards trend of housing starts in the month of April. In the resale market, the recovery is more robust. Sales were up by 0.6% in April compared with the previous month. The median price of homes is still heading up, and the proportion of forced sales, such as foreclosures, continues to drop: it has fallen from 28% of total sales in April 2012, to 18% in April 2013.

Business confidence slips, while consumer confidence improves

The purchasing managers' index in the manufacturing sector, which reflects business confidence, fell by 1.7 points, reaching 49% in May. The new orders index lost 3.5 points, while production lost 4.9 points; both ended up below the 50 mark.

Since the middle of 2011, the index has oscillated around 52% (Graph). Keep in mind that an index below 50 indicates contraction in the manufacturing sector, but as long as it stays above 42.2%, it tells us that the economy in general is expanding. Meanwhile, the consumer confidence index has improved significantly, rising from 69.0 in April to 76.2 in May, its highest level in five years (76.4 in February 2008). Consumers have a more positive view of the current economic situation and are more optimistic about outlooks for growth and employment. ■

Purchasing Manager Index
(January 2008 - April 2013, %)



INTEREST RATES

The key interest rate holds steady at 1.0%

On May 29, the Bank of Canada left the key interest rate unchanged at 1.0%, where it has stood since September 2010. The Bank's opinion on economic outlooks has not changed since the publication of the April edition of the Monetary Policy Report. It anticipates that global economic growth will be modest in 2013 and that it will continue over the next two years. In Canada, residential investment will keep declining, while non-residential investment will grow steadily. Exports

should keep recovering, but their growth will be held in check by weak global demand and the strong Canadian dollar. The first-quarter real GDP data prove the Bank right as far as residential investment is concerned, but not quite so with respect to non-residential investment and exports. The central bank will probably revise its forecasts between now and the next time it sets the key interest rate, on July 17. At that point, the monetary policy committee will be chaired by the Bank's new governor, Stephen Poloz. ■

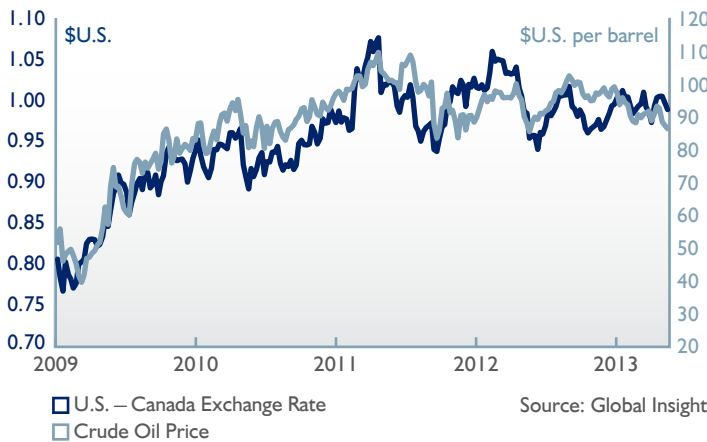
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The price of oil falls, and the Canadian dollar depreciates

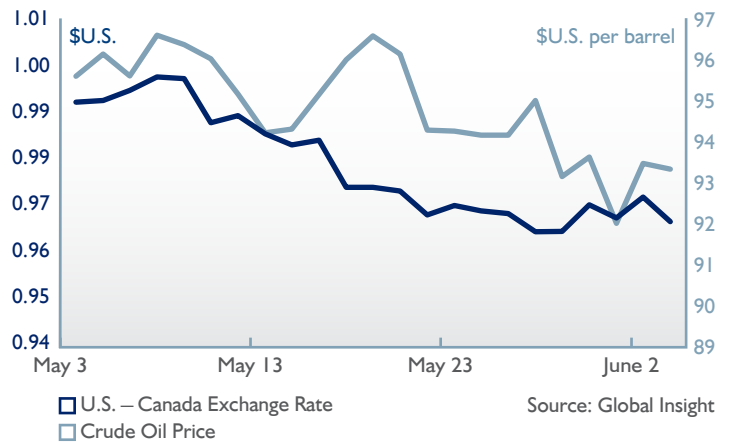
The price of crude oil has been heading down in recent weeks. According to data from the U.S. Department of Energy, crude reserves in the United States have reached their highest level in 31 years. Furthermore, OPEC has decided to leave its cap on crude oil production where it stands, even though observers had been anticipating a reduction. As a result of these two factors, the supply

is larger than expected. Meanwhile, the recession in Europe and the slowdown of the Chinese economy continue to raise concerns about future demand for oil. Lastly, the President of the U.S. Federal Reserve has said that he is prepared to slow down the injections of liquidity into the system if growth firms up; this has also helped to drive crude prices down. In tandem with the slump in the price of crude, the Canadian dollar has depreciated against the American currency (Graph). ■

Exchange Rate and Crude Oil Price
(January 2009 to June 2013)



Exchange Rate and Crude Oil Price
(May 3, 2013 to June 4, 2013)

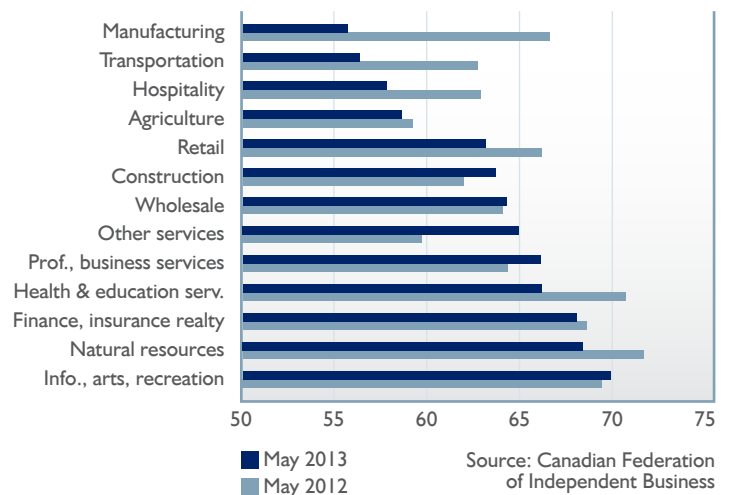


SME CONFIDENCE

Business confidence falters again

In May, the Canadian Federation of Independent Business (CFIB) Business Barometer Index recorded its third straight monthly drop. It lost 0.3% to reach 62.1, its lowest level since September 2012. In the past 12 months, the confidence of SME owners has deteriorated in most of the sectors. At present, manufacturing is the sector where business owners' confidence is weakest, whereas in May 2012, that sector's index was the fifth highest (Graph). The transportation and hospitality sectors have also posted major pullbacks in the past 12 months and are now at the back of the pack. On the other hand, nationwide, apart from Newfoundland and Labrador where confidence has risen significantly since May 2012, the ranking is more or less the same as it was 12 months ago: business owners in the western part of the country are generally more optimistic than those in the centre and the east. It is interesting to note that the percentage of business owners who believe that the lack of domestic demand is limiting sales or production growth has gradually increased in recent months. This is consistent with the weak growth in domestic demand observed in the first quarter of 2013. ■

Business Barometer, by sector
(Index 0-100)





BUSINESS CREDIT CONDITIONS

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Bank credit growth remains strong

Short-term credit granted to businesses by the chartered banks climbed by 14.2% in April compared with the previous month, while long-term credit, which represents 12.8% of total bank credit, ticked up by a mere 0.3%. The 12-month percentage change in all bank credit dipped slightly in April, but at 13.0% it is still high (Graph). ■

Business Credit from Chartered Banks (January 2005 - April 2013, year-over-year change (%))



Source: Bank of Canada

KEY INDICATORS — CANADA

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Key indicators – Canada	Historical ¹				2013 ²				2013 ³	Forecast		
	2009	2010	2011	2012	Q1	Q2	Q3	Q4	Latest	2013	2014	
Real GDP (% growth)	-2.7	3.4	2.5	1.7	2.5				Mar	0.2	1.7	2.5
Machinery and Equipment Expenditures (% growth)	-21.2	10.6	8.6	5.2	-0.7						2.7	6.1
Pre-Tax Corporate Profits (% growth)	-45.4	61.6	16.6	-8.2	16.7						0.8	5.4
Industrial Production (% growth)	-10.9	6.3	3.8	0.9	6.0				Mar	0.6	1.4	2.5
Industrial Product Prices (% growth)	-3.5	1.0	4.6	0.6	0.9				Apr	-0.8	1.4	2.1
Non-Residential Construction (% growth)	-19.4	17.3	12.9	6.9	1.5							
Housing Starts ('000 units)	148	191	193	215	174				Apr	176	175	172
Personal Expenditures (% growth)	0.3	3.5	2.3	1.9	0.9						2.0	2.1
Consumer Price (% growth)	0.3	1.8	2.9	1.5	1.6				Apr	-0.2	1.4	1.9
Employment (% growth)	-1.6	1.4	1.5	1.2	0.8				May	0.1		
Unemployment Rate (%)	8.3	8.0	7.5	7.3	7.1				May	7.2	7.1	6.9
SMEs Confidence Index (CFIB)	57.7	66.7	66.4	63.9	64.9				May	62.1		
Manufacturers Confidence Index (CFIB)	56.0	68.6	67.2	66.7	69.0				May	55.6		

1. Annual growth rate

2. Quarterly growth, at annual rate

3. Month-over-month growth

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business.

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