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economic LETTER

JANUARY 2014

CANADIAN GDP GROWTH SHOULD ACCELERATE IN 2014

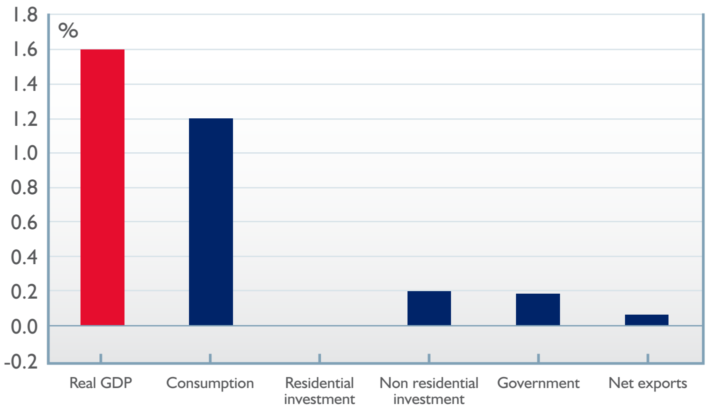
At the beginning of last year, forecasters were anticipating, on average, that real GDP growth would reach 1.9% in the United States and 1.8% in Canada in 2013.[1] With three quarters' worth of data accumulated, the current expectations are 1.7% for both Canada and the United States, so the original forecasts should prove fairly accurate. For 2014, the experts were predicting (still at the beginning of 2013) that economic activity would accelerate in both countries, with real GDP growth of 2.5% in Canada and 3.0% in the United States. Since then, these numbers have been revised downwards. The current forecasts are 2.3% for Canada and 2.6% for the United States.

In 2013, it was mainly consumption that supported economic growth in Canada (Graph 1). The real estate market cooled in most parts of the country, so home-building made no contribution at all to growth. Investment in non-residential construction and in purchases of machinery and materials did not increase substantially – especially in the natural resources sector – despite the solid financial position of private businesses and low interest rates. The reluctance of businesses to invest may be attributed to several factors that have created a climate of uncertainty and curbed Canadian exports, such as the recession in Europe, the weakness of the U.S. recovery and the slowing of growth in emerging economies. The decline in many commodity prices has also contributed to a slowdown of investment activity in the natural resources sector. Lastly, net exports contributed very little to growth in 2013.[2]

For 2014, forecasters are anticipating that investment and net exports will provide more support for economic growth. These expectations are largely based on the assumption of accelerated economic activity in the United States. Current trends in the main indicators seem to confirm that growth is firming up south of the border. Employment growth is on a steady upwards course, and the housing market is continuing to improve. Real GDP growth would have been far more robust in 2013 were it not for the higher taxes and reduced spending that the U.S. government imposed as part of its budget reform efforts. The Bank of Canada estimates the effect of those measures to be 1.8%. In other words, without that effect, U.S. real GDP growth would have reached 3.5% in 2013 instead of 1.7%. The negative effect of the budget restrictions will persist in 2014, but it will be reduced by about one half.

1 The source of these data is Consensus Economics Inc. which surveys a large number of forecasters (including 28 in the United States and 16 in Canada) in some 20 countries.
2 The contribution to growth by net exports is positive, because the trade deficit narrowed.

Graph I: Contribution to Canadian real GDP growth in 2013*



* Average of the three first months of 2013 over the average of the same months in 2012. The contributions do not add to real GDP growth because of the rounding.

Source: Statistics Canada

As was the case in Canada, it was mainly consumer spending that supported economic growth in the United States in 2013. Nevertheless, growth in consumer spending was moderate, held in check by the higher personal income taxes mentioned above. Thanks to improvement in the financial position of households – their debt ratio has fallen considerably, while the net value of their assets has increased quite a bit – it is likely to accelerate in 2014. We also expect stronger growth in private-sector investment. At the end of December, the U.S. Federal Reserve (Fed) announced that it would gradually start reducing its monthly purchases of government securities starting in January 2014, but that the key interest rate would remain within a range of 0 to 0.25% for as long as the unemployment rate remains above 6.5%, and even for quite some time after it reaches that threshold, provided that inflation stays below the long-term target of 2%. Consequently, U.S. businesses are likely to keep enjoying credit conditions favourable to investment in 2014.

This will doubtless also hold true for Canadian businesses. In its latest press releases on monetary policy, the Bank of Canada has omitted to mention, as it had been doing for several months, that a normalization of the key interest rate was to be expected as economic conditions improved. Consequently, forecasters have postponed their expectations of a key interest rate hike to the beginning of 2015. This means that interest rates should remain low and keep stimulating demand and investment in Canada in 2014.

Of course, it is a given that economic forecasts are subject to risk. Since an acceleration of growth in Canada depends on that of the United States, the risks hinge mainly on what happens south of the Canadian border. For example, we still do not know whether the Fed will manage to wind down its quantitative easing without disrupting the global economy. Last summer, the mere announcement of a future reduction of asset purchases by the Chair of the Fed triggered a sudden increase in bond yields in the United States and other parts of the world, along with a significant outflow of capital in many emerging economies. It goes without saying that any deterioration in credit conditions in emerging economies would seriously compromise their prospects of growth and would have serious repercussions on the advanced economies, like those of the United States and Canada. But, contrary to what happened last summer, the recent announcement of tapering of asset purchases was well received by the markets, doubtless thanks to the assurance that the Fed would keep the key interest rate at floor level for a long while to come.

Meanwhile, the Democrats and the Republicans appear to be on the verge of reaching an agreement on the budget, but the issue of raising the debt ceiling has yet to be resolved. Were this dispute to persist and lead to a shutdown of government services, as was the case last October, the U.S. economy could suffer.[3] However, since both parties have managed to agree on the budget, it is likely that they will do the same for the debt ceiling. Lastly, even though the latest data show that economic growth is firming up in the United States, the recovery is still fragile. That said, the numbers could also come in stronger than expected.

Lastly, neither the United States nor Canada is immune to the turbulence that could arise in the global arena. Moreover, forecasts of growth in both these countries are based on a number of assumptions that might not pan out; in particular, that the European economy will get back on a path to growth in 2014, and that economic growth will be sustained in emerging economies.

Overall, the risks appear to be limited. It is reasonable to hope that Canadian economic activity will accelerate as predicted in 2014, in order to resume a more steady cruising speed in the years to come. ■

3 That said, we do not know what effect the federal government shutdown had in October. It probably affected consumer and business confidence and, consequently, held back growth in consumption and investment. We will have to wait for the release of U.S. real GDP data for the fourth quarter of 2013, at the end of January, to get a clearer idea about this.

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Real GDP by industry started off the fourth quarter on the right foot, but an expanding trade deficit and a slump in housing starts in November, and a pull-back in employment in December, tell us that real GDP growth in 2013 will probably not exceed the Consensus forecast of 1.7%.

Real GDP: the fourth quarter of 2013 gets off to a good start

Real GDP expanded by 0.3% in October after a similar increase in the previous month. Production rose by 1.3% in the manufacturing sector, while it remained flat in the construction and the mining and oil and gas extraction sectors. The beverage and tobacco products, food, primary metal manufacturing and transportation equipment sectors are those that made the greatest contribution to manufacturing production growth. Among the service-producing industries, nearly all the sectors advanced, with the exception of arts, entertainment and recreation. Wholesale trade, transportation and warehousing and management of companies and enterprises recorded the sharpest growth month over month.

Employment contracts

In December, 60,000 full-time jobs were lost, while slightly over 14,000 part-time jobs were gained, resulting in a total employment contraction of 45,900 jobs. The unemployment rate ticked up from 6.9% in November to 7.2% in December.

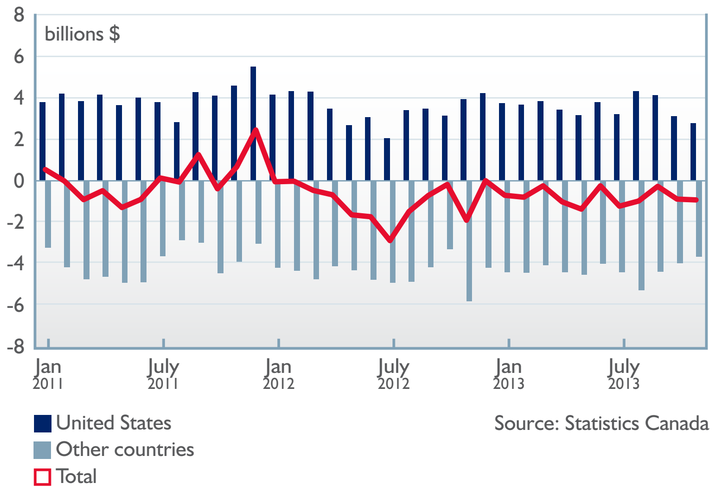
Employment and Unemployment Rate
(2003 to 2013)

Using the annual average to calculate employment, it grew by 1.3% in 2013, compared with 1.2% in 2012. The unemployment rate has fallen very slightly, from 7.2% in 2012 to 7.0% in 2013 (Graph). As shown in the graph, despite the increase in employment, the unemployment rate is still high compared with where it stood prior to the recession.

The trade deficit widens slightly

Canada's trade deficit widened slightly, from $908 million in October to $940 million in November. This reflects a 0.1% monthly increase in the value of imports, while the value of exports remained stable. In real terms, imports dipped by 0.2% in November compared with the previous month, and exports by 0.4%. Canada's trade surplus with the United States narrowed, from $3.1 billion in October to $2.7 billion in November, and Canada's trade deficit with countries other than the United States shrank from $4.0 billion to $3.7 billion over the same period. This is the third month in a row that the trade surplus with the United States has narrowed while the trade deficit with the rest of the world has shrunk (Graph).

Canadian Trade Balance
(January 2011 to November 2013)



Housing starts decline

The number of housing starts fell by 4.1% in December compared with the previous month. In the urban centres, starts of single-family homes were down by 4.1%, and those of multiple-unit homes by 6.7%. The long-term trend, based on the average of the past six months, which had been up slightly in April, stayed relatively stable during the last quarter of the year (Graph). In 2013, the total number of housing starts lost ground compared with the year before, from 215,226 units to 187,980 units, a 12.7% drop. (The annual averages were calculated based on seasonally adjusted data; in real terms, the results may be slightly different. The exact data will soon be released by the Canada Mortgage and Housing Corporation.) The CMHC is forecasting that the number of housing starts in 2014 will be similar to that of 2013.

Housing Starts
(January 2010 to December 2013)

Total
6-month average

Source: Canada Mortgage and Housing Corporation

UNITED STATES

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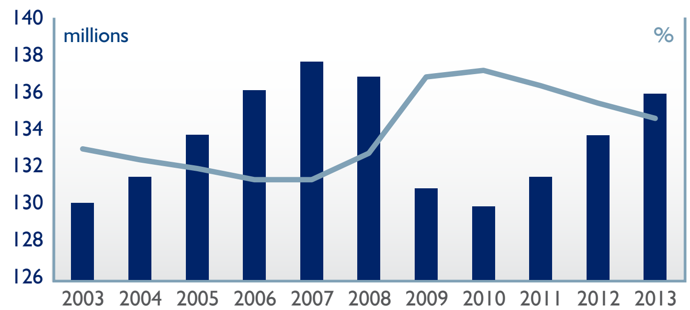
The latest indicators show that economic growth is getting stronger. Employment kept on growing in 2013, and homebuilding, which was the core of the economic slump in 2008, has also turned the corner. However, there is still a way to go before the economy gets back to its pre recession cruising speed.

Employment expands moderately

Employment expanded moderately in December with a gain of 74,000 jobs, its weakest monthly result of the year. The unemployment rate fell, from 7.0% in November to 6.7% in December. For the year 2013 as a whole, employment grew by 2.2 million jobs, a similar increase to that of the year before. The unemployment rate dropped from an average of 8.1% in 2012 to 7.4% in 2013 (Graph). Thus the job market kept on improving in 2013, but things are still far from rosy. The participation rate is much lower than it was before the recession: 63.2% in 2013, whereas it was around 66.0% prior to 2008. The number of discouraged workers (those who have stopped looking for a job because they are convinced they will not find one) has diminished in recent years, but is still nearly twice as high as it was before the recession (861,000 in 2013, versus approximately 450,000 before 2008). Lastly, the number of people who are working part-time for economic reasons (because they were unable to find full-time work, or because their employers reduced their work hours) has remained high since the recession (7.9 million in 2013, versus approximately 4.5 million prior to 2008).

Employment and Unemployment Rate*
(2003 to 2013)



Employment
Unemployment rate

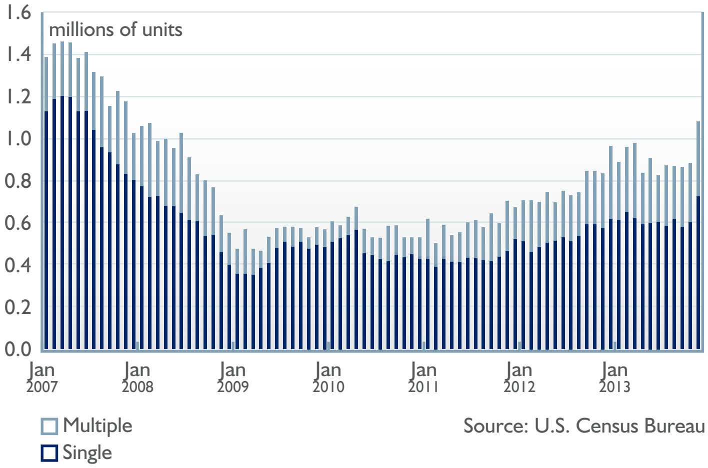
Source: U.S. Bureau of Labour Statistics

* Non-farm employment excluded

Housing starts soar, while sales of existing homes slow

The number of housing starts surged by 22.7% in November compared with the previous month. In the single-family homes segment, starts rose from 602,000 units in October to 727,000 units in November, a 20.8% increase, and in the multiple-unit sector, starts shot up from 281,000 units to 354,000 units, a 26.0% increase (Graph). Meanwhile, sales of existing homes fell by 4.3% in November compared with October. For the first time in 29 months, they were also down compared with the same month of the previous year, by 1.2%. According to the National Association of Realtors in the United States, sales are being held in check by higher mortgage rates, a weak supply and restrictive lending conditions. There is pent-up

Housing Starts
(January 2007 to November 2013)



Source: U.S. Census Bureau

demand, but the supply is insufficient due to the slow pace of the recovery in new homebuilding. These conditions are putting upwards pressure on rents and on home prices. In fact, in November, home prices recorded their highest annual growth rate in eight years.

Business owners are still positive, and consumers are more optimistic

The purchasing managers' index compiled by the Institute for Supply Management dipped by 0.3% in December, reaching 57%, a level that is still quite high compared with the results of the past 18 months. The new orders index reached its highest level since April 2010, and the respondents' comments about economic activity in the last month of the year were very positive. As for consumers, their confidence rebounded in December and has nearly returned to where it stood in September, before the temporary shutdown of government services in early October. That said, even though the tone is more positive, the fact remains that the number of respondents who believe that jobs are hard to find is nearly three times higher than the number of those who believe that there are plenty of jobs available (32.5% vs. 12.2%), which shows that the job market situation is still a source of concern. ■

INTEREST RATES

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Canada's key interest rate should remain stable at 1.0% in 2014

The Bank of Canada's next rate-setting date is January 22, 2014. The central bank will no doubt leave the key interest rate at the level where it has stood since September 2010, i.e. 1.0%. Forecasters do not anticipate any hike in Canada's trendsetting interest rate before the beginning of 2015. Meanwhile, the Fed announced in December that it would start scaling back its monthly purchases of mortgage-backed securities and Treasury bills in January. The Fed asserted that it anticipated, based on its analysis of the current economic conditions and financial market trends, that it would be appropriate to leave the benchmark interest rate at a range of 0 to 0.25% well after the unemployment rate falls back below 6.5%, in order to achieve its objectives of controlling inflation and maximizing employment. Bringing the current quantitative easing to an end without generating turbulence and without slowing down the U.S. economy will be the challenge facing the next Chair of the Fed, Janet Yellen. She will replace Ben Bernanke, whose term ends on January 31, 2014. ■

OIL AND THE LOONIE

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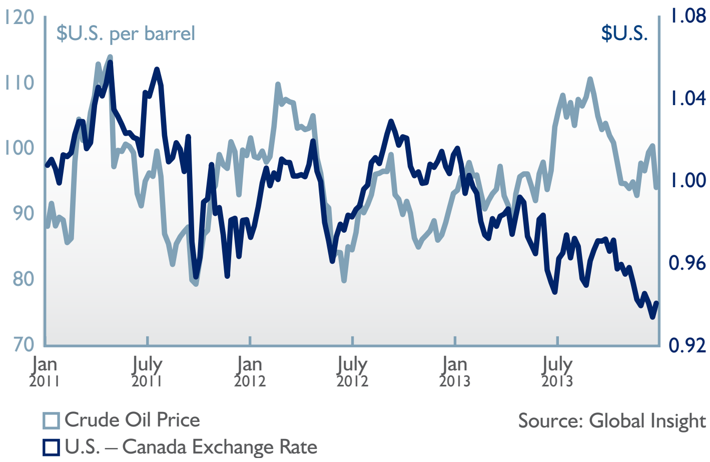
The price of oil stabilizes, the Canadian dollar continues to depreciate

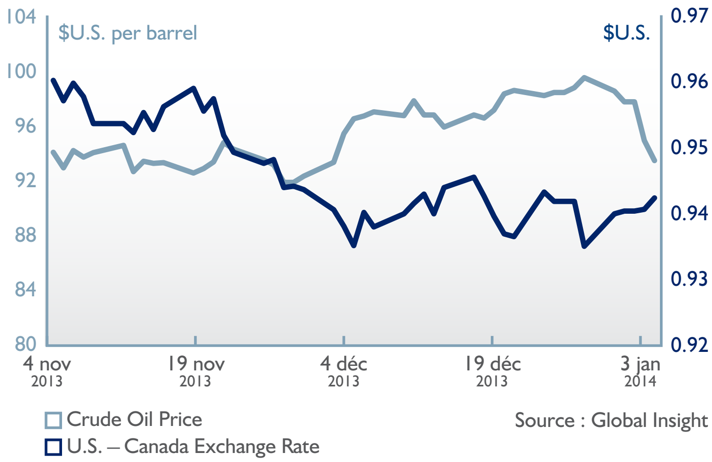
The price of crude oil rose in December, surpassing the threshold of US$100 at the end of the month due to a sharper-than-expected decline in oil inventories in the United States. It subsequently fell back to the level where it stood at the beginning of December, pushed down by the resumption of oil operations in Libya and an increase in oil production in the United States. As for the Canadian dollar, it continued to depreciate in December. Inflation is weak in Canada, below the low end of the Bank of Canada's target range, which has led the central bank to stop hinting at an eventual increase in the key interest rate; meanwhile, the recovery of the U.S. economy is holding steady, to the extent that the Fed has announced that it will gradually bring its quantitative easing to an end. The consequence of the deviations in monetary policy between the two countries is that the loonie is losing ground against the greenback. ■

Exchange Rate and Crude Oil Price
(January 2011 to January 2014)



Source: Global Insight

Exchange Rate and Crude Oil Price
(November 4, 2013 to January 3, 2014)



Source : Global Insight

SME CONFIDENCE

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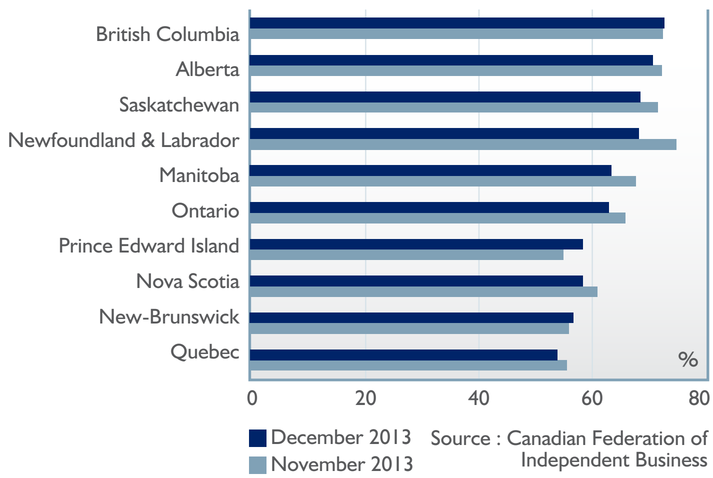
SME owners are less confident

The Canadian Federation of Independent Business's Business Barometer Index dropped significantly in December, falling by 3.5 points to reach 62.3. Thus it has lost nearly all the gains that had been won during the second half of 2013. SME owners' confidence flagged in the majority of sectors, especially retail trade (-6.8 percentage points), manufacturing (-5.5 points), information, arts and entertainment (-4.5 points) and construction (-4.2 points). From a regional perspective, seven provinces out of ten recorded pullbacks in December. The rankings of the provinces remained the same as in November for all the provinces except for Newfoundland and Labrador, where business owners were the most optimistic in November, and Prince Edward Island, where they were the most pessimistic. In December, it was British Columbia that ranked highest, and Quebec that stood at the bottom (Graph). ■

Business barometer, by province
(November and December 2013)



Source : Canadian Federation of Independent Business

BUSINESS CREDIT CONDITIONS

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Growth in short-term bank credit rebounds

After slowing to 0.7% in October, monthly growth in short-term credit granted to businesses by the chartered banks rebounded to 16.7% in November. As for long-term credit, it rose by 5.8% during the month. Year over year, total bank credit to businesses was up by 10% in November. The financial conditions facing businesses are still favourable. Despite a slight increase during the summer of 2013, the effective interest rate for businesses – a weighted average of various bank interest rates and market interest rates, applicable to new loans granted to non-financial businesses – remains low relative to historic levels (Graph). ■

Effective Business Interest Rate
(January 2007 to November 2013, weekly data)

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	2.3	1.6	2.7		Oct	0.3	1.7	2.3
Machinery and Equipment Expenditures (% growth)	-21.2	10.6	8.6	5.2	0.7	-0.2	2.5				1.5	4.8
Pre-Tax Corporate Profits (% growth)	-45.4	61.6	16.6	-8.2	9.4	-39.9	66.7				-4.6	4.8
Industrial Production (% growth)	-11.0	6.0	3.9	0.9	6.0	-2.7	3.0		Oct	0.6	1.2	2.2
Industrial Product Prices (% growth)	-3.5	1.0	4.6	0.6	4.5	-1.0	1.6		Oct	0.3	0.9	1.6
Non-Residential Construction (% growth)	-19.4	17.3	12.9	6.9	1.9	-1.9	2.1					
Housing Starts (' 000 units)	148	191	193	215	170	190	195	197	Dec	190	187	179
Personal Expenditures (% growth)	0.3	3.5	2.3	1.9	1.1	3.6	2.2				2.2	2.2
Consumer Price (% growth)	0.3	1.8	2.9	1.5	1.6	0.0	1.5		Nov	0.0	1.0	1.5
Employment (% growth)	-1.6	1.4	1.5	1.2	0.8	1.3	0.8	0.9	Dec	-0.3		
Unemployment Rate (%)	8.3	8.0	7.5	7.3	7.1	7.1	7.1	7.0	Dec	7.2	7.1	6.9
SMEs Confidence Index (CFIB)	57.7	66.7	66.4	63.9	64.9	61.3	64.8	64.4	Dec	62.3		
Manufacturers Confidence Index (CFIB)	56.0	68.5	67.3	66.7	65.6	58.3	65.4	65.8	Dec	66.4		

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.