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economic LETTER

APRIL 2014

THE LIMITS TO GROWTH ACCORDING TO THE BANK OF CANADA

The Canadian dollar has gradually depreciated against the U.S. currency since mid-2013. This state of affairs is largely due to the fact that the economic outlook is better in the United States than in Canada: the forecasts of real GDP growth in the United States are 2.8% for 2014 and 3.1% for 2015, versus 2.2% and 2.5%, respectively, in Canada.[1] Moreover, while the latest indicators appear to confirm that growth in the United States is firming up, the Canadian data are mixed and suggest that growth could be more sluggish than forecast.

The monetary policies that are being conducted on either side of the border reinforce these expectations. In the United States, the Federal Reserve considers that the signs of strengthening in the economy are sufficiently positive for it to keep tapering its government asset purchases. Certainly, the Fed is still being cautious and asserts that it expects the key interest rate to remain at floor level for a good while after the quantitative easing comes to an end, but its tone is resolutely positive. As for the Bank of Canada, it considers that exports are still disappointing and that the turnaround in business investment has been unexpectedly slow. It predicts some acceleration in economic growth in 2014, but expresses concern about the downside risks for inflation. In short, the central bank's message is less optimistic than it was six months ago, when it suggested an eventual "gradual normalization of interest rates."

The recent speech given by the Governor of the Bank of Canada on the limits to growth also helped accentuate the divergence between these two outlooks. Stephen Poloz talked about the long-term weakness in economic growth, both in Canada and in the world, since the financial crisis. In his view, this persistent weakness, unusual for a period of recovery, could be due to two things: a) the effects of the financial crisis and b) a change in the long-term economic growth trend.

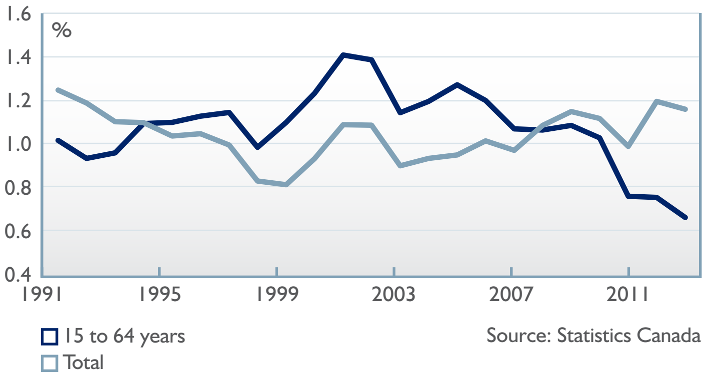
Historically speaking, it has been observed that recovery takes longer after a financial crisis than it does when it occurs as part of a normal economic cycle, due to the necessity for businesses and consumers to put their financial affairs in order. To do so, both businesses and households must reduce their debt, which translates into a slowdown in investment and consumption. Once their financial

1 Consensus Economics Inc., March 10, 2014.

position is back on a firm footing, demand increases and economic growth gets back on track. Therefore, the effect associated with the financial crisis should be only temporary.

However, economic growth may now be following a slower long-term trend due to the demographic changes that are underway in many advanced economies. Economic growth is supported by expansion of the labour supply and growth in productivity. In Canada, for example, due to the aging of the population, growth in the population of people of working age has been declining in the past few years, and this trend will continue (Graph). Furthermore, many baby-boomers have retired and others are preparing to do so. They have therefore reached a time of life when they save more and consume less. This behaviour by a group that represents a large proportion of the population has the effect of limiting economic growth.

Annual Change in the Canadian Population
(1991 to 2013)



Source: Statistics Canada

Acceleration in productivity could offset slower growth of the labour force. But during the past decade, Canada's productivity growth has been meagre. One of the explanations put forward by the Governor is the fact that a growing proportion of household savings has been invested in real estate in recent years, whereas it is mainly other types of assets that help to finance business investment and, thus, to increase productivity. The share of total household assets devoted to real estate has risen from 32% in 1999 to 40% in 2012. The Bank of Canada's expansionist monetary policy, adopted to combat the effects of the financial crisis, is largely responsible for this state of affairs.

Investment in real estate has greatly contributed to the economic recovery in Canada, but it cannot support growth indefinitely. The central bank now anticipates that the U.S. economy will firm up, which will stimulate Canadian exports and lead to an increase in non-residential investment. That said, while it projects that Canada's economic growth will be 2.5% in 2014 and in 2015, the Bank expects that, in the longer term, the economy will grow at a pace compatible with the economy's production capacity, i.e. 2.0%.

The central bank is basing its estimate of long-term economic growth on the assumption of productivity growth varying between 1% and 1.5%. If productivity growth were greater than that, it would compensate more for the slowdown in the growth of the labour force, and long-term growth could then be more than 2%. Therefore, it is important that Canadian businesses continue to innovate and to invest, in order to improve their productivity. ■

CANADA

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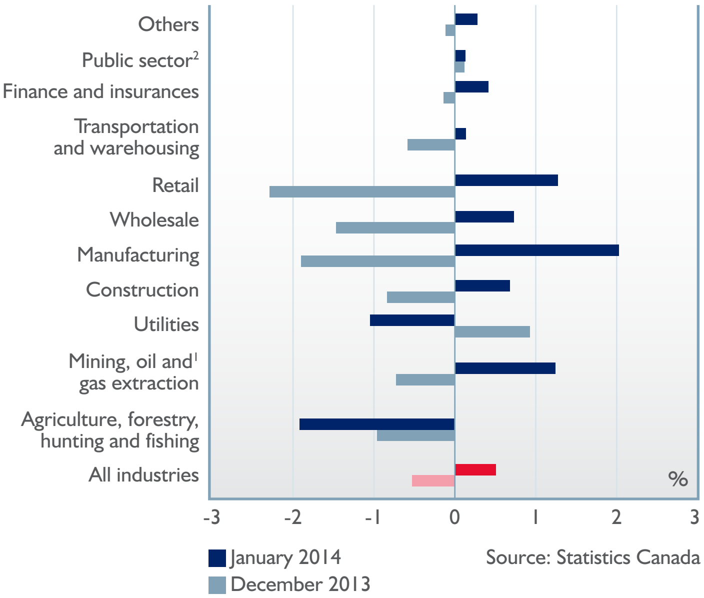
Employment expanded in March, but the gains are concentrated in part-time jobs, which are more precarious. The value of exports rose in the first two months of the year, but their volume shrank during that period. In short, the results are not bad, but they suggest that economic growth was not very strong during the first quarter of the year.

Real GDP regains lost ground

Real GDP rose by 0.5% in January, regaining the ground that was lost in December, when it declined by 0.5%. Production rebounded in all the industries that had suffered a slump in December, with the exception of the agriculture, forest products, hunting and fishing sector (Graph). In that sector, production recorded a greater pullback than in the previous month: 1.9% versus – 1.0%. The January upturn in the GDP is reassuring. According to the most recent Consensus Economics, real GDP will grow by 2.2% in 2014, i.e. at approximately the same pace as in 2013 (2.0%).

Monthly Change in GDP, by industry



1. Includes carrying; 2. Education, health and public administration

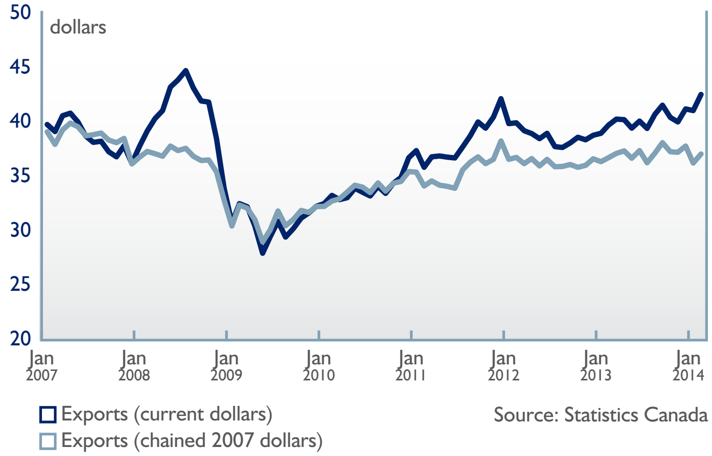
Employment expands

After a loss of 7,000 jobs in February, 43,000 new jobs were created in March. The bulk of the gain comes from employment of young people aged 15 to 24 (a gain of 33,000 jobs in this age group) and from part-time jobs (a gain of 30,100). The unemployment rate dipped from 7.0% in February to 6.9% in March. Over the past 12 months, employment has risen by 1.1%. However, it was mainly part-time jobs that increased during that period, by 1.6% versus 1.0% for full-time jobs. Since part-time jobs are generally more precarious and less well paid than full-time jobs, this indicates some weakness in the job market in the past 12 months.

The balance of trade improves

In February, exports recorded a greater monthly increase than did imports (3.6% versus 2.1%), which translates into an improvement in Canada's balance of trade, from a deficit of $337 million in January to a surplus of $290 million in February. The upturn in exports is mainly attributable to automotive vehicles and energy products. Those same products also account, to a large measure, for the growth in imports. During the first two months of the year, merchandise exports rose by 3.2%, but that increase is entirely due to higher prices. Once corrected to take price variations into account, exports have declined by 2.0% since December 2013. Since 2011, export volume growth as measured using 2007 prices has been much more sluggish than export value growth measured at current prices (Graph).

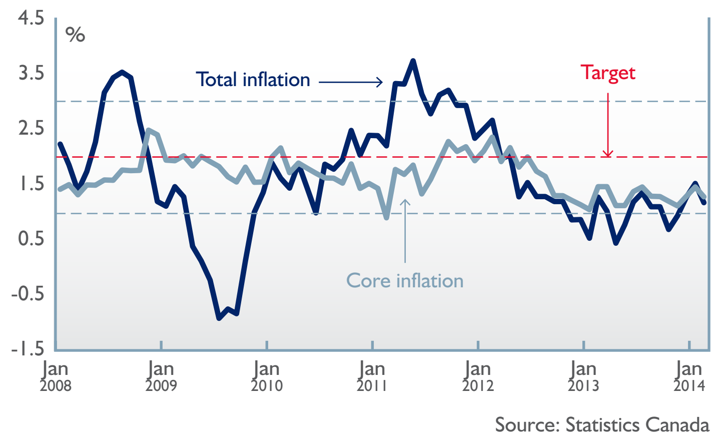
Exports in value and in volume
(January 2007 to February 2014)



Inflation remains low

The all-items inflation rate dropped from 1.5% in January to 1.1% in February. The inflation rate as measured by the Bank of Canada's Core Consumer Price Index, which excludes the most volatile prices like those of energy, came in at 1.2% in February. Whichever measure is used, the inflation rate is still low, well below the central bank's target of 2.0%. According to the Bank, this weak inflation is mainy due to two factors. Firstly, the economy is still running below its production capacity, which means that there is little pressure on prices and salaries; and, secondly, competition in the retail sector is tending to limit price increases for consumer goods. According to the Bank, inflation should return to the vicinity of the 2.0% target within two years or so.

Inflation Rate
(January 2008 to February 2014)



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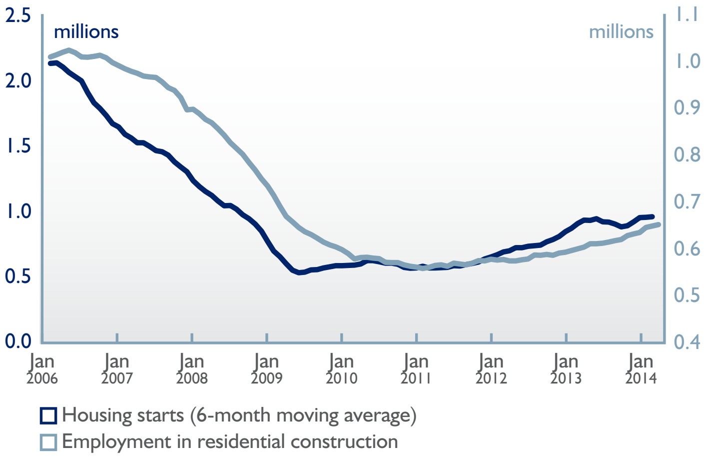
UNITED STATES

Employment keeps resolutely climbing, and business and consumer confidence are improving. Housing market activity pulled back during the first two months of the year, but this seems largely attributable to the harsh weather conditions that battered several parts of the country. These results bode well and suggest that growth will strengthen in 2014, as expected.

Employment continues to rise

The job market expanded by 192,000 jobs in March, and the gains of February and January were revised upwards by 37,000 jobs. Taking these revised figures into account, the average monthly variation in employment reached 187,000 over a period of one year in March. The unemployment rate was static, at 6.7%. It was the sector comprising professional, scientific and technical services and business services that recorded the greatest job gains during the month. In the manufacturing sector, employment has varied very little: over the past 12 months, this sector recorded an employment gain of just 0.6%. On the other hand, things are clearly improving in the homebuilding sector, where employment has expanded by 8.0% in the space of a year. That increase should continue when housing starts pick up again (Graph).

Employment in residential construction and housing starts
(Januray 2006 to March 2014)

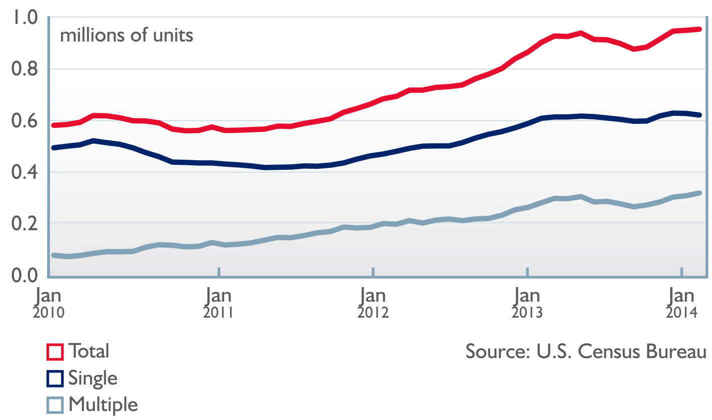


Sources: U.S. Bureau of Labour Statistics et U.S. Census Bureau

The housing market is chilled by bad weather

Housing starts in February were practically flat from the previous month, dipping from 909,000 units in January to 907,000 units in February. Their trend, measured by the six-month moving average, has stabilized in recent months. It managed to maintain an upwards course in the multiple-dwelling segment, while it headed down in the single-family segment (Graph). The slowdown in housing starts is no doubt partly attributable to the harsh weather conditions that have held sway in many parts of the United States, and that have also put a damper on the resale market. In fact, home sales have recorded their sharpest monthly pullback since July 2012. That said, the small inventory of homes for sale also accounts for the slowdown in real estate activity. When better weather comes, housing starts and home sales should resume their upwards trend.

Housing Starts
(6-month moving average, January 2010 to February 2014)



Source: U.S. Census Bureau

Business and consumer confidence both gain ground

The manufacturing purchasing managers' index compiled by the Institute for Supply Management, a leading indicator of economic growth in the United States which also reflects business confidence, gained 1.9 percentage points to reach 53.2%, despite the 6.6 percentage point drop in the production sub-index. As was the case in January, many respondents mentioned that inclement weather had disrupted their activities in February. The Conference Board's consumer confidence index is also up: it climbed from 78.3 in February to 82.3 in March. The sub-index that measures consumers' assessment of their present situation, which had been improving steadily over the past four months, was little changed in March, but the sub-index that measures their expectations about the future of the economy rebounded. ■

INTEREST RATES

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No change in sight for the key interest rate

On April 16, the Bank of Canada will announce its next decision on the target for the overnight rate. Forecasters anticipate that the Bank will leave the interest rate where it has stood since September 2010, i.e. at 1.0%. On the same day, the Bank will release its quarterly report on monetary policy, which will include an update of its forecasts of economic growth in Canada. Little change is expected from the forecasts that were stated in the January report. At present, economists are not expecting any hike in the key interest rate before the second or third quarter of 2015.

OIL AND THE LOONIE

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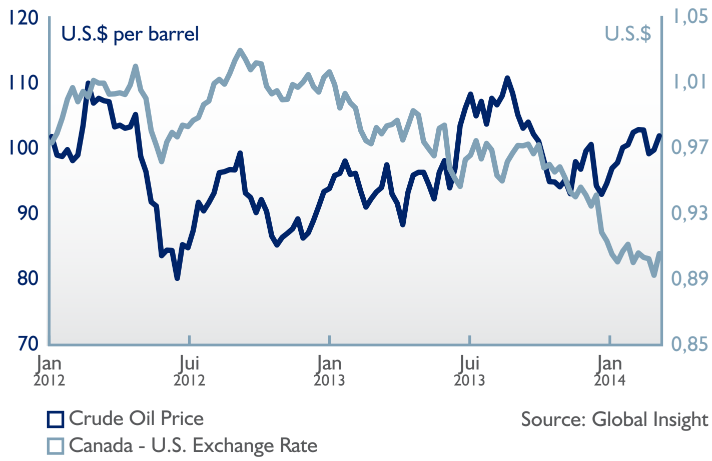
The price of oil and the Canadian dollar stabilize

The price of crude oil rose during the first two months of the year due to concerns aroused by the conflict between Ukraine and Russia, but it stabilized in March, as the situation did not trigger the oil supply disruptions that had been feared. It is still high, however, because investors are watching closely to see how the conflict unfolds, and are remaining cautious. The Canadian dollar, which has depreciated considerably against the U.S. dollar since the middle of 2013, mainly due to the divergences between economic outlooks in Canada and the United States, stabilized in March at around US$0.90.

Exchange Rate and Crude Oil Price
(January 2012 to March 2014)



Source: Global Insight

SME CONFIDENCE

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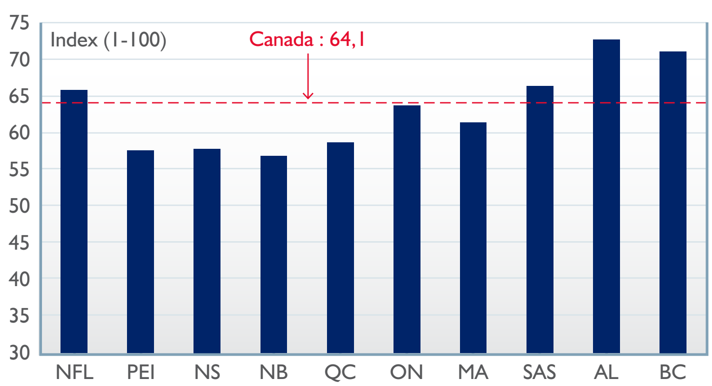
SME owners remain confident

The Business Barometer Index compiled by the Canadian Federation of Independent Business held steady during the first three months of the year, hovering at around 64 points. The agriculture and transportation sectors show the lowest readings–below 60 points–while the information, arts and recreation sector is the only one whose reading surpasses 70 points. The deviations between the regions are more pronounced: with the exception of Newfoundland and Labrador, SME owners in the eastern part of the country, including Quebec, are less optimistic than those in the west, including Ontario (Graph). Hiring intentions are still good, with 38% of business owners planning to hire full-time staff in the next three to four months, versus 7% who are considering staff cuts.

Business Barometer, by province
(March 2014)



Source: Canadian Federation of Independent Business

BUSINESS CREDIT CONDITIONS

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Growth in bank credit granted to businesses keeps slowing down

Short-term bank credit granted to businesses declined by 3.2% in February compared with the previous month, while long-term credit (12.8% of the total) dipped by 2.3%. Over a 12-month horizon, the growth in credit granted to businesses by chartered banks has continued to decelerate, falling from 9.3% in January to 7.3% in February. Based on the trend in the effective interest rate for businesses – a weighted average of various bank and market interest rates that apply to new loans granted to non-financial firms – the cost of credit that businesses are facing is still very affordable (Graph). ■

Effective Business Interest Rate
(January 2007 to March 2014)

Source: Bank of Canada

KEY INDICATORS – CANADA

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Key indicators – Canada

	Historical[1]				2013[2]				Latest		Forecast	
	2009	2010	2011	2012	Q1	Q2	Q3	Q4			2014	2015
Real GDP (% growth)	-2.7	3.4	2.5	1.7	2.9	2.2	2.7	2.9	Jan	0.5	2.2	2.5
Machinery and Equipment Expenditures (% growth)	-21.2	10.6	8.6	5.2	-0.7	-0.4	-4.3	3.2			3.1	5.9
Pre-Tax Corporate Profits (% growth)	-45.4	61.6	16.6	-8.2	25.7	-28.0	36.1	5.7			5.0	5.5
Industrial Production (% growth)	-11.0	6.0	3.9	0.9	6.2	-2.0	3.4	5.6	Jan	1.3	2.3	2.5
Industrial Product Prices (% growth)	-3.5	1.0	4.6	0.6	4.5	-1.0	1.6	-16.9	Jan	0.0	1.3	2.0
Non-Residential Construction (% growth)	-19.4	17.3	12.9	6.9	2.8	-1.0	2.6	-4.0				
Housing Starts (' 000 units)	148	191	193	215	170	190	195	195	Feb	192	180	177
Personal Expenditures (% growth)	0.3	3.5	2.3	1.9	1.0	3.5	2.4	3.1			2.3	2.2
Consumer Price (% growth)	0.3	1.8	2.9	1.5	1.6	-0.1	1.9	-0.9	Feb	0.8	1.5	1.9
Employment (% growth)	-1.6	1.4	1.5	1.2	0.9	1.2	0.8	0.9	Mar	0.2		
Unemployment Rate (%)	8.3	8.0	7.4	7.3	7.1	7.1	7.1	7.0	Mar	6.9	6.9	6.6
SMEs Confidence Index (CFIB)	57.7	66.7	66.4	63.9	64.9	61.3	64.8	64.4	Mar	64.1		
Manufacturers Confidence Index (CFIB)	56.0	68.5	67.3	66.7	65.6	58.3	65.4	65.8	Mar	64.3		

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.