

**ECONOMIC PROSPECTS FOR CANADA:
SPRING 1997**

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When the country's unemployment figures for January 1997 were released, the press noted the apparent contradiction between the predictions of strong economic growth for Canada and our stubbornly high unemployment rate, now stalled at 9.7%. January's job creation record of 5,000 was far fewer than the 50,000 new jobs predicted and put in doubt the forecast of 300,000 new jobs for Canada in 1997. The February numbers were even worse. Not only did the unemployment rate stay at 9.7%, the economy lost 19,000 jobs.

Indeed, looking only at unemployment rates gives little sense that the economy is improving; this would seem not to bode well for the provincial budgets forthcoming later this spring, and might make one view more cautiously the forecasts in the budgets already tabled. This reaction would be mistaken, however. The prospects for the national economy look rosy indeed and the impact on government budgets should be strongly positive.

Last fall, the monetary policy report of the Governor of the Bank of Canada forecast that real growth in Canada would exceed a rate of 4% in 1997, well above the 3% average of private sector forecasts for the year. More recent private sector analyses suggest that the Bank was not far off the mark. In January of this year, the Scotiabank forecast 3.4% growth for 1997 and the TD Bank is predicting 3.3%. The Royal Bank is predicting 3.3% growth for 1997 and 3.5% for 1998, in both instances calculated as average annual growth rates. When measured as the change from the fourth quarter of one year to the next, growth is expected to be 3.6% in each of 1997 and 1998. Also measuring this way, the Bank of Montreal believes that the economy will grow by 3.8% in 1997. The Conference Board of Canada is more pessimistic than these banks, however, having recently forecast only 2.9% growth in 1997.

The optimistic predictions are quite credible, once it is recognized that the economy is already growing at a healthy pace. Canadian economic growth in the third quarter of 1996 was 3.3% at annual rates. In the fourth quarter it fell to 2.9% at annual rates, due to a decline in GDP in December attributed to poor weather and the large drop in exports resulting from the GM strike. The temporary drop in exports was countered by a strong upsurge in domestic demand, however, which at 1.8% growth in the fourth quarter, was the best since 1987. Business investment in machinery and equipment was also up substantially in the latter half of 1996, suggesting that the effects of low interest rates are finally beginning to take hold. By the end of the year, investment was 16% higher than in 1995. A recent Statistics Canada release predicts that total capital spending will grow by 5.2% in 1997, fueled by an expected 7.8% growth in capital spending by the private sector. Consumer spending also grew during the last quarter of 1996, primarily in interest-sensitive areas. Thus the optimistic forecasts for 1997 represent a continuation of the situation already existing in the last half of 1996.

The American economy, which has been the source for much of our own growth, is continuing to expand at a healthy pace. Inflation in both Canada and the United States remains under control and nominal interest rates here, at historically low levels, have apparently finally spurred an increase in domestic demand in Canada.

The negative developments are either temporary in nature (major strike, poor winter weather) or will soon have run their course (government layoffs and fiscal restraint, private sector economic restructuring). Positive developments appear to be longer term in nature. There is no real sign that the low inflation and low interest rate environment is about to change. The Royal Bank, for example, expects only a minimal increase in Canadian short-term interest rates to the end of 1998. Although longer term rates are expected to rise more, the Canadian economy should face low inflation and low interest rates for at least the next two years. So, unlike the case in past economic cycles, no speculative bubble needs to be burst by restrictive monetary policy. Indeed, the only real concern at present is the view of some, most notably Alan Greenspan, the Chairman of the U.S. Federal Reserve, that equity markets are overly optimistic and hence over-priced.

It is not obvious, however, just what the Federal Reserve could, or should, do about this perceived problem. Central banks are usually concerned with overall inflation, not price changes concentrated in specific markets, even those as important as the financial equity market. If this "excessive" optimism largely results from low inflation in product markets and low interest rates, any move by the Federal Reserve to tighten monetary policy would in the

longer run only reduce inflation and interest rates further and could produce even more optimism in equity markets in the future. Thus, despite the recent words of Mr. Greenspan, nothing in today's economic environment suggests that monetary policy needs to be significantly tightened to fend off any inflationary pressures.

Strong economic growth means strong revenue growth for governments and reduced program spending in areas sensitive to the economic cycle. When we couple this with low and stable interest rates, the forecast for government deficits is extremely favourable. Last year's federal and provincial budgets forecast total deficits at \$34.9 billion for 1996-97. The federal deficit target for this year was \$24.3 billion; however, according to the 1997 federal budget, it will be no more than \$19 billion, and some analysts expect it to be lower still. The Alberta surplus, because of the province's strong growth and extremely prudent revenue forecasts, is now projected to be about \$2 billion more than predicted by the budget, while the Ontario economic accounts are on track for a deficit about \$1 billion less than predicted. So, despite the controversy over the British Columbia surplus that wasn't, governments' books are in better shape than predicted last year and total deficits could be almost 25% lower than forecast.

The recent improvement in the fiscal position of several governments has led commentators to refer to the "virtuous circle" of tight fiscal policy. Alberta, for example, has already taken all the tough measures needed. Its very prudent budget accounting, coupled with strong growth, enabled it to pay down some of the debt and is now allowing it to add fiscal stimulus through tax cuts, more public investment and reduced debt servicing costs. The Ontario government will not have to impose any new restraint measures and will continue with its tax cuts. The federal government is not adding any additional restraint measures to its fiscal policy.

While there are good prospects for growth, it is not expected to be spread equally across the country. According to Scotiabank, Alberta and Ontario will lead the way by a significant margin, with growth rates of 4.6% and 4.2% respectively (see Chart 1). In Ontario, growth is being led by a booming manufacturing sector, fueled by export demand and growing consumer spending encouraged by low interest rates and personal income tax cuts. In Alberta, growth is the result of a healthy resource sector that is prompting a variety of large capital projects in the resource development, chemical and natural gas transmission sectors. The next highest provincial growth rate is in British Columbia, at 2.9%; this province's growth in 1997 should pick up substantially from its performance in 1995 and 1996. The Conference Board is, again, less optimistic than the banks cited here but it, too, sees growth being concentrated in Ontario and Alberta.

In the short run, the end of current mega projects will have a significant and negative impact on the economy of Atlantic Canada, although these projects do offer the prospect of higher future growth. The Prince Edward Island economy is still suffering from reduced activity after the completion of the fixed link, while Newfoundland's growth is being curtailed by the winding down of Hibernia construction. Nevertheless, that province should see positive growth in 1997 for the first time in three years and several resource-related developments portend stronger growth in the near future.

The only remaining significant provincial deficits will be in Ontario and Quebec, and it is here that the contrast between a fast-growing economy and a lagging one should be most evident. Last year's Quebec budget predicted a balanced budget by the year 2000, a goal that is now enshrined in law, and initiated a series of spending restraint measures. Several analysts have suggested, however, that additional, substantial cuts will be needed to meet the target, one reason being that Quebec revenues are more than \$700 million below forecast levels. Indeed, the recently released Quebec estimates for 1997-98 contain \$2.3 billion in new cost-cutting efforts.

There is the possibility that Quebec is counting on overly optimistic growth rates. Quebec's growth is expected to lag behind the national average by an increasingly large amount; in 1995, it was 83% of the national average. This ratio is expected to fall to 62% for 1996 and (with a growth rate of 1.8% predicted by Scotiabank for 1997) to fall further, to 53%, in 1997. The Conference Board is predicting much lower growth for Quebec, only 0.7% in 1997. On the other hand, while last year Quebec's own budgetary forecasts for 1996 and 1997 were close to private sector estimates, the province is predicting growth of 2.4% per year for 1998 and after. These Quebec growth forecasts are not unachievable, nor are they unreasonable, given longer term trends. They would, however, require that Quebec growth rates re-establish their more traditional relative standing vis-à-vis Ontario. The recently released Regional Economic Outlook published by the Bank of Montreal is more optimistic about the Quebec economy, predicting 2.75% growth in 1997 and 3% in 1998. If the Quebec economic situation of the mid-1990s proves to be an aberration, the strong economic trends for the national economy should soon be enjoyed there as well, helping the province to progress towards a balanced budget, like Ontario, Alberta and several other provinces. If not, Quebec's budget plans could be derailed.

In Ontario, by contrast, though the deficit for 1997-98 is projected to be a slightly larger percentage of GDP than in Quebec (see Chart 2), and the economy has lost over 50,000 jobs in the past six months, the economy is more favourable, while there are more tax cuts to

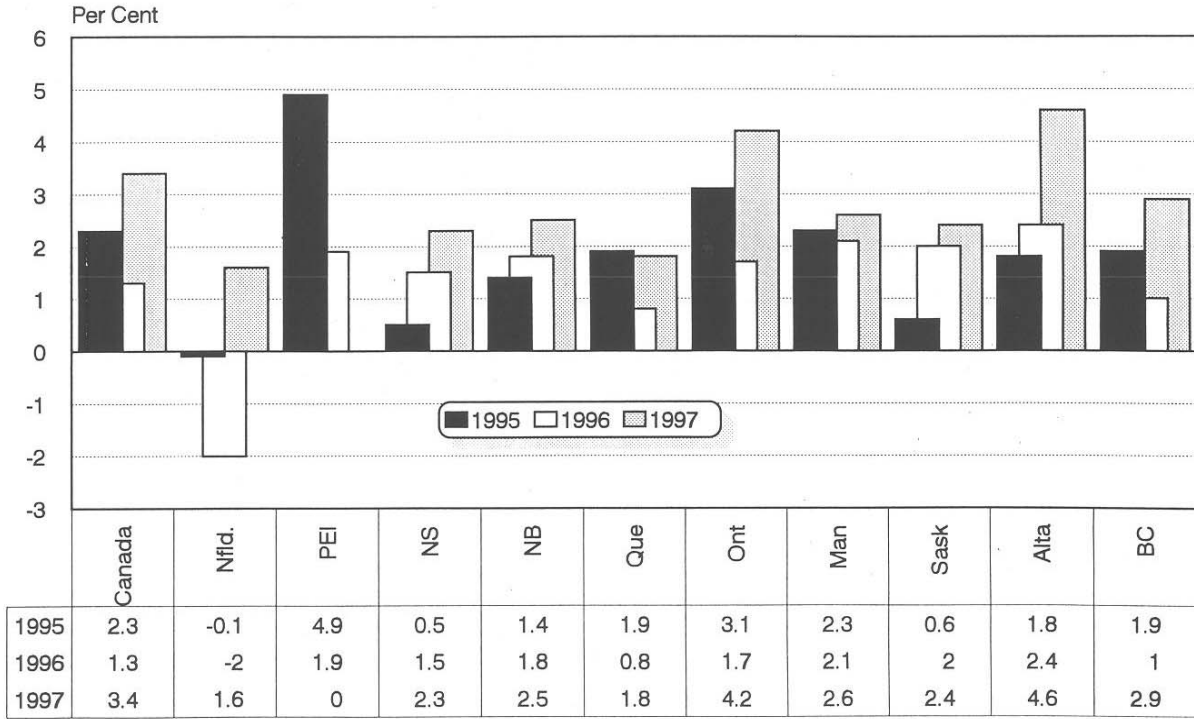
come and no new restraint measures. Moreover, the use of very prudent economic assumptions means there is little chance of unpleasant surprises in this province. The Ontario government's growth projections are 2.8% growth for 1997 (substantially below private sector forecasts) and 3% for 1998.

The other province facing hard budget choices is British Columbia. After last year's admission by the government that the budgetary numbers were incorrect, a number of austerity measures were announced in a province that, being accustomed to strong economic growth, had not yet had to take the same tough measures as other provinces. This situation has now changed. The government's task is eased, however, by the fact that the deficit is not nearly as large as those of Ontario and Quebec; debt servicing costs in BC take up only 5% of revenues, compared to more than 15% in Ontario and Quebec. In addition, the BC government has taken capital spending off the books for budget purposes; hence, a balanced budget will represent a more modest achievement here than in the other provinces.

CHART 1

**Economic Growth in Canada
1995 to 1997**

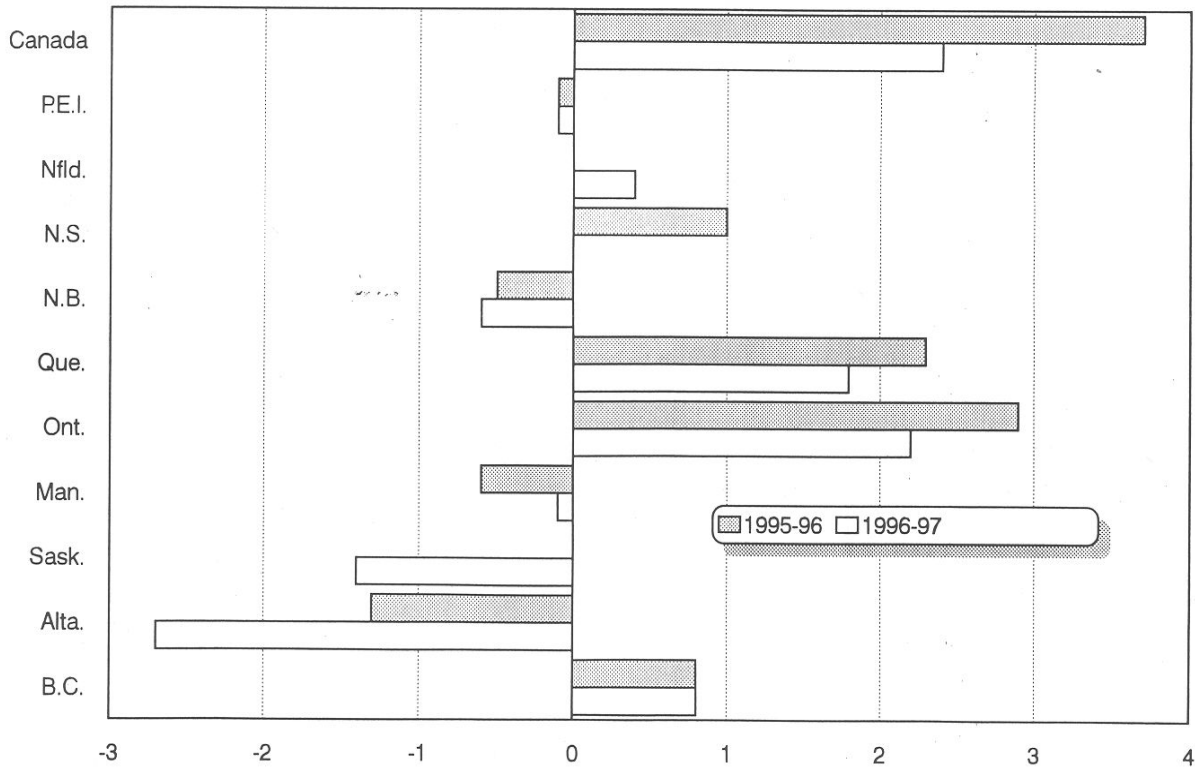
Annual Rates of Growth



Source: Scotiabank, January 1997.

CHART 2

**Government Deficits as a % of GDP
1995-1996 and 1996-1997**



A negative entry represents a surplus.

Source: TD Bank, as revised by Library of Parliament.