

economic LETTER

OCTOBER 2011



GLOBAL ECONOMY WILL BE WEAKER THAN EXPECTED

The International Monetary Fund (IMF) has scaled down its projections for the global economy for 2011 and 2012 for two major reasons. First, the economic recovery in the advanced economies since the beginning of the year has been slower than expected, and second, fiscal and financial uncertainty has ballooned, especially since August.

In June the IMF had expected that demand from the private sector would take over from the public sector, which did not happen for different reasons in different countries, such as a shortage of bank credit, problems in the real estate sector and the high level of household debt. The IMF had also counted on a rebalancing of external accounts, hoping that some Asian countries, and particularly China, would stimulate domestic rather than foreign demand, which they did not. As a result, many advanced economies, including the United States, were unable to compensate for weak domestic demand with exports.

In addition, the IMF had not anticipated the growing scepticism from financial markets about the ability of certain countries to put their fiscal houses in order. The sovereign debt problem, which initially affected only a few European countries, expanded significantly and engulfed more European countries as well as the United States and Japan. Financial markets are worried about the solvency of banks that hold government bonds, especially in Europe. This has led to tighter credit and falling stock prices.

All of these factors led the IMF to take a less positive view. The biggest change concerns the United States, for which growth forecasts were lowered by one percentage point in 2011 and 2012. Declining consumer and business confidence caused by losses on the stock market, weak real estate prices and fiscal consolidation will depress growth in the U.S. The outlook for the euro zone was scaled back by approximately half a percentage point. The turmoil on European financial markets will weaken consumer and business confidence, which will curb investment and consumer spending in Europe.

So far, the emerging countries have emerged unscathed. They should continue to post strong growth in 2011 and 2012, but it should be lower than in 2010 as their international trade will feel the effects of weak growth in the advanced economies.

Lastly, the IMF also revised the growth expected in Canada downward. It recognizes that the fundamentals are relatively healthy in Canada and thinks ▼

Canada

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United States

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BDC's Monthly Economic Letter is produced by the Strategy and Corporate Development department and is based on a variety of public sources of economic data. The information in this letter is drawn from data released prior to October 1st. Reliance on and use of this information is the reader's responsibility.

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that commodity prices will help us, but also that our very close economic ties to the United States will expose us to our neighbour's expected slowdown.

We should point out that the IMF's scenario assumes that European policymakers manage to contain the sovereign debt crisis, that the Americans succeed in striking a balance between fiscal consolidation and economic recovery initiatives, and that volatility in global financial markets does not escalate. With all these factors in play, there are serious risks that could threaten the IMF's projections. ■

Real GDP annual growth (%)

	2009	2010	Forecasts			
			For 2011		For 2012	
			Sept 2011	June 2011	Sept 2011	June 2011
World	-0.7	5.1	4.0	4.3	4.0	4.5
Advanced economies	-3.7	3.1	1.6	2.2	1.9	2.6
United States	-3.5	3.0	1.5	2.5	1.8	2.7
Euro Area	-4.3	1.8	1.6	2.0	1.1	1.7
Canada	-2.8	3.2	2.1	2.9	1.9	2.6
Emerging economies	2.8	7.3	6.4	6.6	6.1	6.4
China	9.2	10.3	9.5	9.6	9.0	9.5
India	6.8	10.1	7.8	8.2	7.5	7.8
Brazil	-0.6	7.5	3.8	4.1	3.6	3.6

Source: World Economic Outlook, International Monetary Fund, September 2011.

CANADA

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Canada is not immune from what is happening in the rest of the world, as demonstrated by the drop in consumer confidence, which was shaken by the volatility that hit stock markets in recent months in reaction to the sovereign debt crisis in Europe and weakness in the U.S. economy. However, after dipping in the second quarter, production started to pick up again in July, which is a sign that the fundamentals of the Canadian economy are healthy and that many sectors of the economy are continuing to take advantage of this.

Real GDP growing

Real gross domestic product rose 0.3% in July, after increasing 0.2% in June. After three consecutive monthly declines, manufacturing production grew 1.4%. Public services, transportation & warehousing and wholesale trade were some of the other sectors that helped drive growth in July, while retail trade and construction fell off.

Consumer confidence holds steady

The Conference Board Consumer Confidence Index barely changed, edging up from 74.7 in August to 75.0 in September. In August the Index had lost 6.6 points, continuing the downward trend that began in May. The percentage of respondents who thought their financial situation was better than it had been six months earlier was lower than the percentage who thought it was worse. Furthermore, although the percentage of respondents who expect their financial situation to improve in the next six months is higher than the percentage who expect the opposite, the balance of opinion on this question has eroded constantly since the beginning of the year, probably in response to the stock market volatility that dominated this period.

Index of Consumer Confidence (2002 = 100)



Source: The Conference Board of Canada

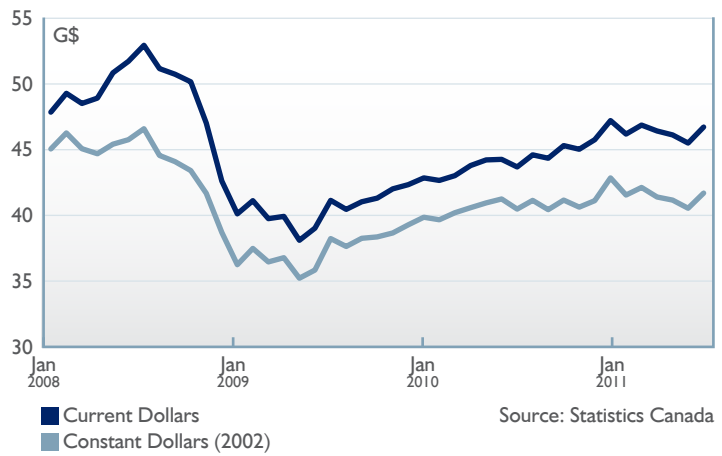
Retail sales decline

After rising for three months in a row, retail sales were down 0.6% in July. Sales of motor vehicles and auto parts were largely responsible for this decline. If these components are excluded, retail sales posted zero growth. In volume, retail sales fell 0.9% in July after rising 1.6% in June. Furniture and home furnishings stores as well as sporting goods, hobby, music and book stores were hardest hit, while food and beverage stores as well as miscellaneous store retailers posted the largest increases. July's retail sales results were disappointing but consistent with the decline in consumer confidence from May to August, and suggest that the growth in consumer spending could be slower in the third quarter than in the second. ▼

Manufacturing sales rebound

Manufacturing sales rose 2.7% in July after three consecutive monthly declines. The increase was quite generalized, as fifteen of the 21 industries – i.e. 75% of total manufacturing production – posted increases. In the petroleum and coal industry as well as in the primary metal manufacturing industry, the increases followed production slowdowns due to maintenance work in June. In addition, after rising 2.0% in June, new orders were up a further 1.3% in July, which augurs well for manufacturing sales in the coming months. ■

Manufacturing Shipments



★ UNITED STATES

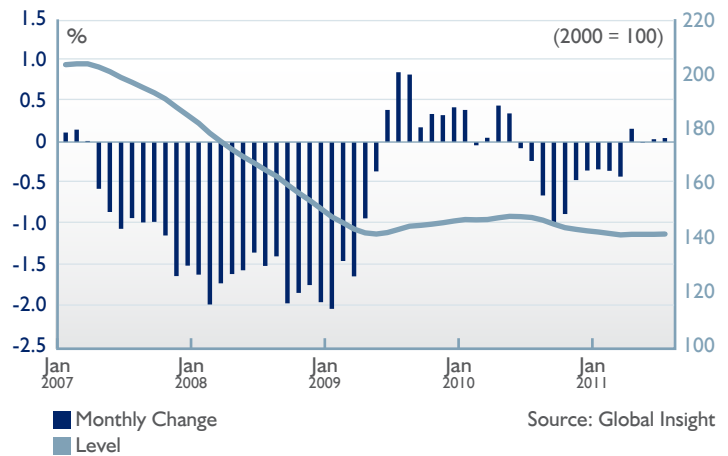
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The small amount of data that has been issued since the last monthly Economic Letter did little to improve the economic outlook: existing home prices seem to have stabilized but we are still waiting for a sustainable recovery in sales, and residential construction remains anemic. Consumer confidence is weak, which is putting a damper on consumer spending.

Existing home sales up but housing starts down again

Housing starts declined 3.2% in August from the previous month, after dropping 2.2% in July. Single family home starts were down 3.2% while multiple-unit housing starts fell 12.4%. In addition, new home sales were 2.3% lower in August than July. Existing home sales, on the other hand, jumped 7.6% in August from the previous month and home prices seem to be stabilizing, as shown by the S&P/Case-Shiller Home Price Index, which has held steady for the past few months (see chart). According to the National Association of Realtors, consumers are attracted by favourable buying conditions but are worried about the economic outlook and the turmoil on stock markets, which is slowing the recovery on the real estate market.

S&P/Case-Shiller Existing Home Price Index



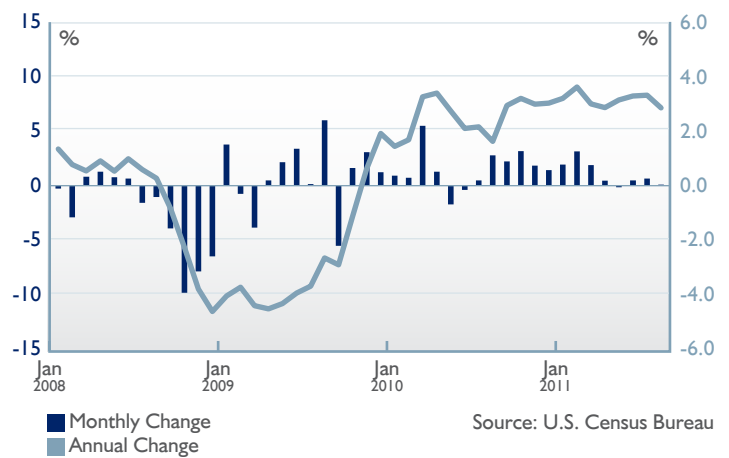
Consumer confidence still weak

The U.S. Conference Board Consumer Confidence Index, which had declined sharply in August, remained essentially unchanged in September, with a slight increase from 45.2 to 45.4. Despite this improvement over the previous month, the percentage of respondents who expect an improvement in the short-term outlook is still much lower than the percentage who expect it to worsen (11.3% vs. 22.6%). Consumers also remain pessimistic about employment prospects and are increasingly concerned about their future income, two findings that do not bode well for consumer spending in the coming months. ▼

Retail sales stabilize

After a 0.3% increase in July, retail sales stayed at the same level in August, but this was 7.2% higher than in August 2010. Not including sales of motor vehicles and auto parts—which dipped 0.3% in August—retail sales edged up 0.1%. The monthly growth in retail sales has been quite weak in recent months, as the chart below shows, which points to a slowdown in the growth of consumer spending in the third quarter. ■

Retail Sales Growth



INTEREST RATES

No change in key interest rate expected before June 2012

With the ongoing sovereign debt crisis in Europe and persistent concerns about the weakness of the U.S. economy, forecasters do not expect any change in the Canadian key interest rate before June 2012 since Canada is not immune from what

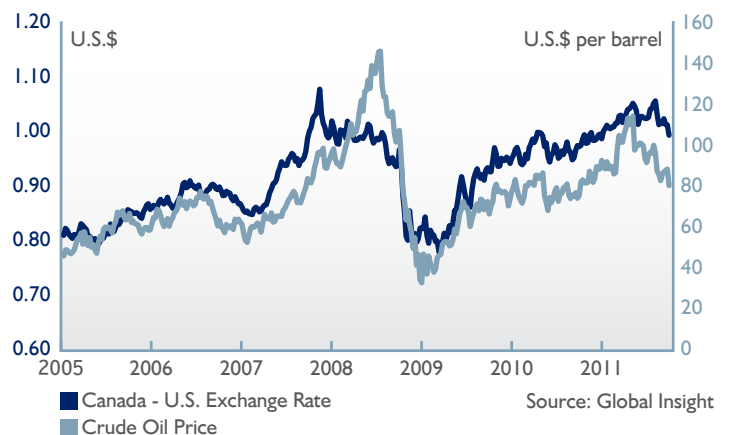
is happening in the rest of the world, and particularly south of the border. The Federal Reserve also announced that it would keep its key interest rate stable until mid-2013 in the hope of bolstering the economic recovery. As a result, both the Canadian key interest rate and the gap between Canadian and American rates should remain stable until mid-2012. ■

OIL AND THE LOONIE

Price of gas falls and Canadian dollar depreciates

The price of gas continued to fall in recent weeks. Financial markets are sceptical about Europe's ability to resolve the sovereign debt crisis and the Federal Reserve's ability to stimulate the American economy. Fears that the United States will fall back into a recession resurfaced, which drove down the Canadian dollar because of the negative impact this would have on the Canadian economy were it to happen. ■

Crude Oil Price and Canada-U.S. Exchange Rate





BUSINESS CREDIT CONDITIONS

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Business credit continues to rebound

Business credit from chartered banks continued to rise in August. Short-term credit was 11.6% higher than in July, and long-term credit increased 9.7%. Looking at the longer term, business credit from chartered banks is now 15.2% higher than it was in May and 7.9% higher than it was in August 2010 (see chart).■

Business Credit from Chartered Banks



KEY INDICATORS – CANADA

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Key indicators – Canada	Historical				2011				Latest	Forecasts	
	2007	2008	2009	2010	Q1	Q2	Q3	Q4		2011	2012
Real GDP (% growth)	2.2	0.7	-2.8	3.2	3.6	-0.4			Jul	0.3	2.3
Machinery and Equipment Expenditures (% growth)	4.2	-0.5	-19.5	11.8	15.2	31.0					16.5
Pre-Tax Corporate Profits (% growth)	1.9	11.0	-33.1	21.2	19.7	-8.4					13.0
Industrial Production (% growth)	-0.5	-4.5	-9.4	4.6	6.0	-4.9			Jul	0.7	2.8
Industrial Product Prices (% growth)	1.5	4.3	-3.5	1.0	9.6	4.9			Jul	-0.3	4.4
Non-Residential Construction (% growth)	2.3	7.9	-22.2	2.8	10.7	2.0					
Housing Starts (' 000 units)	229	212	149	192	178	193			Aug	185	181
Personal Expenditures (% growth)	4.6	3.0	0.4	3.3	-0.1	1.6					2.0
Consumer Price (% growth)	2.1	2.4	0.3	1.8	3.6	3.1			Aug	0.2	2.8
Employment (% growth)	2.4	1.7	-1.6	1.4	2.4	2.0			Aug	0.0	
Unemployment Rate (%)	6.0	6.1	8.3	-3.1	7.8	7.5			Aug	7.3	7.5
SMEs Confidence Index (CFIB)	67.2	56.1	57.7	66.7	69.2	68.0			Aug	61.7	
Manufacturers Confidence Index (CFIB)	68.8	52.7	56.0	68.6	72.6	71.0			Aug	59.8	

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