Entrepreneurs first

economic LETTER

JULY 2011 – AUGUST 2011

SOVEREIGN DEBT CRISIS STILL UNRESOLVED

It has been more than a year now since the so-called "sovereign debt crisis" began in Europe and the situation, far from being resolved, has deteriorated significantly. To continue receiving help from the European Union (EU) and the International Monetary Fund (IMF), Greece recently adopted a new five-year austerity plan which contains tough fiscal and budget measures (including new hikes in income and other taxes and further cuts to the public service) as well as large-scale privatization of state-owned firms.

Ireland and Portugal also asked the EU and IMF for help and had to come up with serious budget restructuring plans to get it. Other European countries, including those with the heaviest debt burdens like Spain and Italy, have not yet sought outside help but have adopted similar programs. The European Union desperately wants to reassure the markets in order to keep the crisis from spreading to the rest of the eurozone.

However, success is not yet in sight. Moody's rating agency, which questions the effectiveness of Portugal's austerity plan, has downgraded Portugal's rating to "junk bond" status. In addition, Standard & Poor's thinks the European proposal to get private Greek creditors (banks, investment funds, pension funds) involved in helping Greece to finance its debt could well lead to Greece defaulting on its payments. According to the agency, this would be equivalent to Greece declaring bankruptcy.

Obviously, the reaction of the rating agencies creates a vicious circle: it erodes investor confidence, which raises the rates at which these governments can find financing, which then makes their budget situation even worse. Politically, the crisis calls into question the very viability of the European monetary union, which celebrated its twelfth anniversary this year, by showing that it is impossible for member countries to enact exchange rate and interest rate policies that would be helpful in their particular cases.

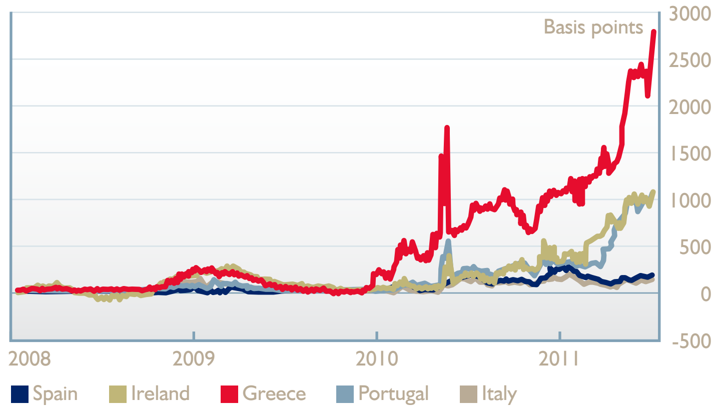
The situation in Europe is likely to remain tense for some time to come. The budget restructuring programs of the countries in difficulty are spread over several years and, even if they are effective, they will not succeed in reestablishing investor confidence in the short term. As a result, the cost of financing some ▼

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 July 13. Reliance on and use of this information is the reader's responsibility.

government debt – which has soared since the crisis began, as shown in the graph – is not expected to return to normal levels any time soon.

Although Canadian banks do not hold a large amount of debt of the worst hit European countries, Canada is not immune from the fallout from this crisis according to the Bank of Canada. First, Canadian banks are indirectly exposed through foreign financial institutions that do hold this debt. Second, a worsening of the situation in Europe could drive up risk premiums or reduce the availability of financing on world markets. This would result in losses for financial institutions around the world, including in Canada, and could jeopardize the global economic recovery. This is a serious risk that the central bank considers "the principal risk for Canadian financial stability" at the present time.[1]

Borrowing costs as measured by 2-year sovereign yield spreads over German bonds



Source: Bank of Canada, Financial System Review, June 2011, Page 8

CANADA

Back

Overall, the latest economic indicators are positive: employment continues its healthy growth, residential construction is stronger than expected and the trade deficit has shrunk. However, the Canadian economy cannot remain impervious to events outside its borders. The weakness of the U.S. economy and the sovereign debt crisis in several eurozone countries are threatening to slow the global economy. Against this background the Bank of Canada may be reluctant to raise the key lending rate.

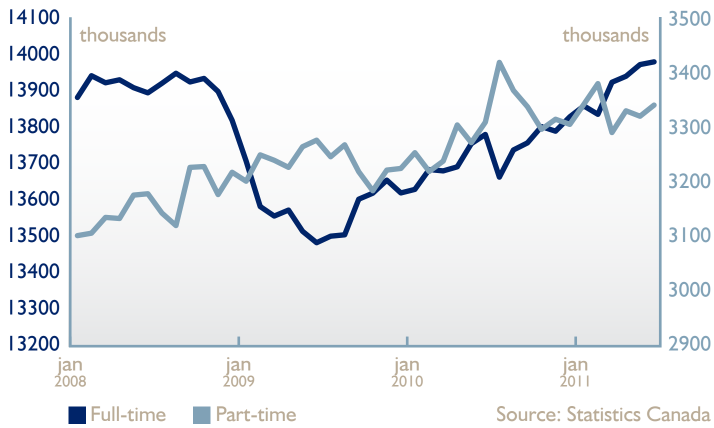
Real GDP unchanged

Real GDP growth stalled in April, with production increases in some sectors being offset by declines in others. The sectors that made gains were mainly mining, retail trade and the public sector (education, health and public administration). The manufacturing and wholesale trade sectors as well as the financial and insurance sectors posted the largest declines. The weaker performance of the manufacturing sector was partly due to the drop-off in motor vehicle production caused by disruptions in the supply of parts following the tsunami that hit Japan in March.

Employment still growing

Employment grew for the third consecutive month in June, adding 28,400 jobs, most of them part time. However, the unemployment rate remained at 7.4% because the labour force expanded. Over the past twelve months 237,500 jobs have been created, including 205,000 full-time positions. The labour market has now recovered all of the full-time jobs lost during the recession and has begun a new period of expansion (see graph above). Sectors posting the largest annual gains included transportation and warehousing, manufacturing and construction while the biggest losses were in trade. Overall, the job market is buoyant, which points to a positive economic outlook.

Employment, full-time and part-time



Source: Statistics Canada

Trade deficit dips slightly

A slightly larger monthly increase in exports (1.2%) than imports (1.1%) resulted in a small decline in the trade deficit from $857 million in April to $814 million in May. The industrial goods, machinery and equipment, and automotive product sectors helped to boost both exports and imports. Exports of energy products fell along with the price of crude oil. In volume, net exports were up in May, offsetting the previous month's decline. The results for April and May suggest that the contribution of net exports to economic growth in the

1 Bank of Canada, Financial System Review, June 2011, page 2

second quarter will not be very substantial, reflecting the strength of the loonie and the weakness of the U.S. economy.

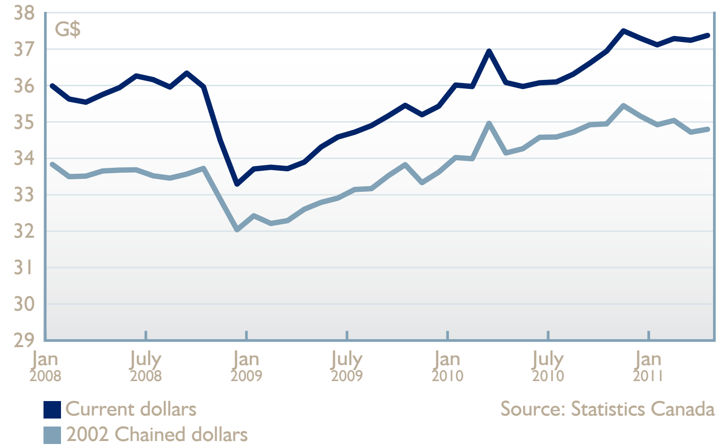
Housing starts on the rise

Housing starts increased from 194,100 units in May to 197,400 in June. Single family home starts in urban areas rose 11.1% while multiple-unit housing starts were down 3.1%. Most of the growth in June was concentrated in Ontario, where urban starts jumped 24.1%. According to Canada Mortgage and Housing Corporation, starts since March have trended higher than expected, but they should soon return to a level more in line with demographic fundamentals.

Retail sales up

Retail sales in April rose by 0.3% from the previous month and by 0.2% if the impact of price variations is excluded. Sales of motor vehicles and auto parts posted the biggest gain in April. Furniture store sales were also up, while retailers of construction materials and gardening equipment and supplies saw the largest decline, probably because of the rainy weather in many parts of the country in April. Retail sales have been on a net upward trend for about two years, but much of the increase in the last six months has been due to rising prices. In fact, as the graph below shows, the volume of retail sales has been trending down since October 2010.

Retail Sales



Source: Statistics Canada

UNITED STATES

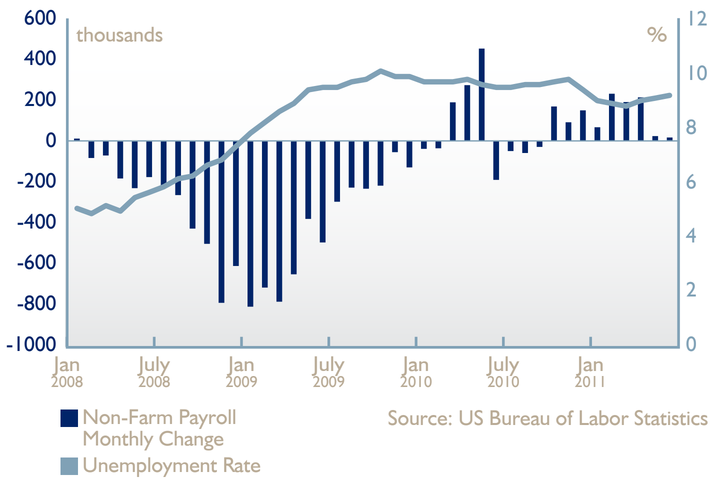
Back

The latest economic data are far from encouraging. Job creation has been anemic in the past two months and consumer confidence is declining, which is reflected in lower consumer spending. Plus the housing sector is still depressed. The only recent positive indicator giving hope for better days ahead is the ISM Purchasing Managers Index that once again points to growth in the manufacturing sector.

Job creation at a standstill

Only 18,000 jobs were added in June, after a modest gain of 25,000 in May, compared to the 215,000 jobs that had been created on average in the three previous months. Unemployment edged up from 9.1% to 9.2%. The private sector added 57,000 jobs. After a good start to the year, job growth has slowed significantly in the past few months and the unemployment rate remains high (see graph below). These results are consistent with the decline in consumer confidence observed in June and do not augur well for economic growth over the short term.

Employment and Unemployment Rate



Source: US Bureau of Labor Statistics

Housing starts up but existing home sales down

Housing starts rose 3.5% in May from the previous month, and building permits were up 8.7%. Sales of existing homes, however, dropped 3.8% in May from April and, despite a small monthly increase, the median price is still 4.8% lower than it was in May 2010. These results reflect the general weakness of the economy plus bad weather, and high gas prices could have dampened the desire to shop for real estate in May. With gas prices falling, the situation could improve in the coming months. However, lending institutions are still risk-averse and many potential buyers who would like to take advantage of very low mortgage rates and depressed house prices find credit hard to get.

Consumer spending declines

Preliminary data from the Bureau of Economic Analysis point to a 0.1% decline in real consumer spending in May, following a similar contraction the previous month. The 0.7% drop in spending on goods in May was partly offset by an increase in spending on services. The results for April and May indicate that the contribution of consumer spending to real GDP growth in the second quarter will be weak or even negative.

Business confidence edges up but consumer confidence falls again

The Institute for Supply Management (ISM) Purchasing Managers Index for the manufacturing sector, which reflects the level of confidence of companies in that sector, recovered a little of the ground lost in April, gaining 1.8 points in May to reach 55.3%. Overall, the index indicates that growth continued in the manufacturing sector in May for the 23rd consecutive month. However, the U.S. Conference Board's Consumer Confidence Index, which had fallen in May, fell again in June. Consumers appear to be less concerned about inflation but are still pessimistic about job growth. ■

Consumer and Business Confidence

INTEREST RATES

Back

Key interest rate to rise more slowly than expected, according to forecasters

The next monetary policy decision by the Bank of Canada will come on July 19. In May the central bank left the key interest rate unchanged but its press release suggested a possible hike in the rate if the Canadian economy remained strong. The Consensus, which had predicted a 100 basis point increase in the key interest rate by the end of the year, has revised its forecast down and now expects a total increase of no more than 50 basis points in 2011. Forecasters believe that the Bank of Canada will be reluctant to tighten its monetary policy due to the risks created by the sovereign debt crisis in Europe and the weakness of the U.S. economy. ■

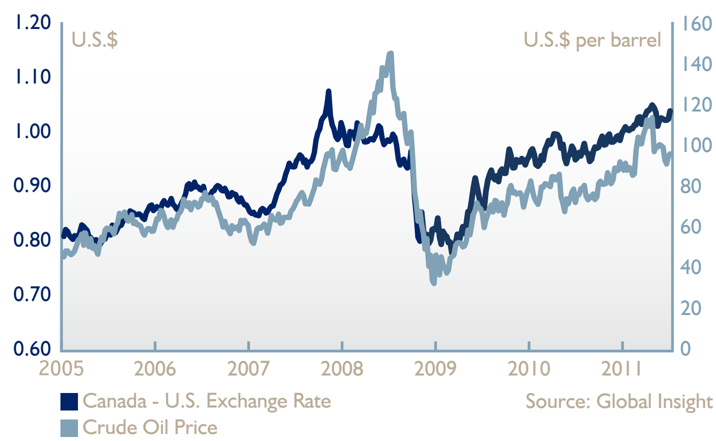
OIL AND THE LOONIE

Back

Price of oil down but Canadian dollar still strong

The price of oil continued to fall in recent weeks due to fears of a global economic slowdown – which are being triggered by the sovereign debt crisis in the eurozone – which would reduce the demand for oil. However, the Canadian dollar remained strong. A more positive economic outlook in Canada than the United States is keeping the value of the loonie high. ■

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



SME CONFIDENCE

Back

Small business leaders' confidence dips slightly

The CFIB Business Barometer Index, which in May had fallen 4 points from April, dipped slightly in June to 66.3, its lowest level in seven months. Although business leaders in the western provinces as well as in Newfoundland & Labrador remain the most optimistic in the country, regional differences were less marked in June because of better results in Ontario, Quebec and Nova Scotia. However, confidence slipped in almost all sectors in June, with the biggest declines in manufacturing, arts and entertainment, wholesale trade and natural resources. In addition, after topping 2% for several months, companies' expectations of increases in their selling prices over the next 12 months declined 1.6% in June, most likely as a result of the recent fall in gas prices. ■

CFIB Business Barometer and Real GDP Growth

(Index of 50 = equal balance of stronger and weaker business expectations)

Index, 0 - 100
GDP : % ch. Q/Q , a.r.

Source: Canadian Federation of Independant Business

BUSINESS CREDIT CONDITIONS

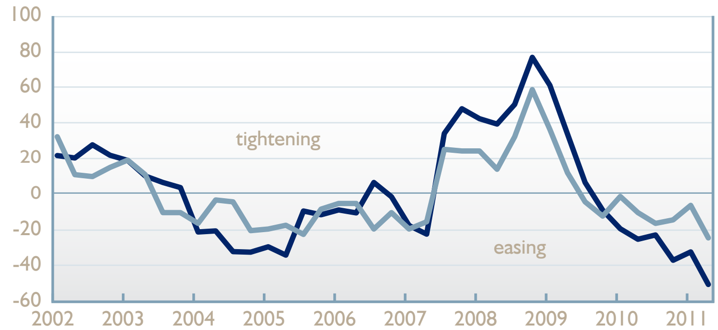
Back

Business credit conditions continue to ease

The results of the Bank of Canada's Business Outlook Survey (BOS) and Senior Loan Officer Survey (SLOS) indicate that business credit conditions continued to ease in the second quarter of 2011. Also, according to the BOS, the easing has expanded to include all sectors, regions and sizes of business (small, medium and large). Business credit from chartered banks continued its uptrend, with the annual growth rate rising from 2.8% in April to 4.2% in May. ■

Business Credit Conditions

(% tightening - % easing)



Business Outlook Survey
Senior Loan Officer Survey

Source: Bank du Canada

KEY INDICATORS – CANADA

Back

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	3.9				Apr	0.0	2.8	2.6
Machinery and Equipment Expenditures (% growth)	4.2	-0.5	-19.5	11.8	15.4						13.5	8.2
Pre-Tax Corporate Profits (% growth)	1.9	11.0	-33.1	21.2	22.1						15.7	7.6
Industrial Production (% growth)	-0.5	-4.5	-9.4	4.6	7.9				Apr	0.0	4.3	3.9
Industrial Product Prices (% growth)	1.5	4.3	-3.5	1.0	9.2				May	-0.2	4.2	4.0
Non-Residential Construction (% growth)	2.3	7.9	-22.2	2.8	11.8							
Housing Starts (' 000 units)	229	212	149	192	175	195			Jun	197	176	176
Personal Expenditures (% growth)	4.6	3.0	0.4	3.3	0.2						2.3	2.4
Consumer Price (% growth)	2.1	2.4	0.3	1.8	3.6				May	0.7	2.8	2.1
Employment (% growth)	2.4	1.7	-1.6	1.4	2.4	2.0			Jun	0.2		
Unemployment Rate (%)	6.0	6.1	8.3	-3.1	7.8	7.5			Jun	7.4	7.5	7.2
SMEs Confidence Index (CFIB)	67.2	56.1	57.7	66.7	69.2	68.0			Jun	66.3		
Manufacturers Confidence Index (CFIB)	68.8	52.7	56.0	68.6	72.6	71.0			Jun	72.3		

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