

# economic LETTER

FEBRUARY 2012



## ECONOMIC OUTLOOK: WHAT CAN WE EXPECT IN 2012?

In the first few months of a new year it is always interesting to look at economic growth forecasts, which is what we will do in this Letter. However, before focusing on 2012, we will look back to see whether the experts got it right for the year just ended. At the beginning of last year, real GDP was forecast to grow 2.3% in Canada in 2011. We do not have all the fourth quarter data yet, but the most recent indicators seem to show that 2.3% is exactly what we will get. However, even though the experts batted a thousand for Canada, they were too optimistic about the United States. The forecast was identical to that for Canada, namely 2.3%, but according to the latest estimates growth in the United States was 1.7% last year, mainly because the recoveries in the labour market and housing sector south of the border were significantly weaker than expected.

For 2012, the forecasts issued by Canadian banks vary between 1.7% and 2.5% for Canada and between 1.8% and 2.5% for the United States, as shown in the table below. The Consensus is 2.0% for Canada and 2.2% for the United States. Most forecasters expect growth to be a little stronger in the United States than in Canada. This reflects trends seen at the end of 2011, when growth seemed to be slowing in Canada and picking up in the United States.

According to most forecasters, the budget austerity measures being implemented by many European countries are likely to result in a recession in the euro zone in 2012. The Bank of Canada estimates that the crisis in the euro area will reduce global GDP by somewhat more than 1% by the end of 2012, including reductions of 0.8% in the United States and 0.6% in Canada. Since trade between Europe and Canada is limited, the impact on our economy from deteriorating economic conditions in Europe will be mostly indirect, through their spillovers on U.S. demand, financial conditions, confidence and commodity prices.

Despite the negative effects of the European crisis, forecasters expect the job market to continue to improve in the United States, and real estate and residential construction to gradually emerge from the quagmire they have been bogged down in for so long. However, the need to reduce the government deficit will hobble growth south of the border. In Canada, low growth in the U.S. economy will limit exports, and the experts fear that the high level of household debt in Canada will curtail consumer spending growth. ▼

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1 See the December 2010/January 2011 Economic Letter.

2 Bank of Canada, Monetary Policy Report, January 2012, page 9.

For 2012, almost all the forecasters agree that the chance of being off the mark is very high and that there are more downside than upside risks because the predictions are based on the assumption that the euro zone crisis will not get worse, which is far from certain. Also, the forecasters may be making the same mistake of being overly optimistic about the American economy. Like last year, many are counting on a recovery in the housing market but it is still very depressed and it is hard to see how it could generate much economic activity in the coming year.

Under these conditions, interest rates should not rise for a long time to come. ■

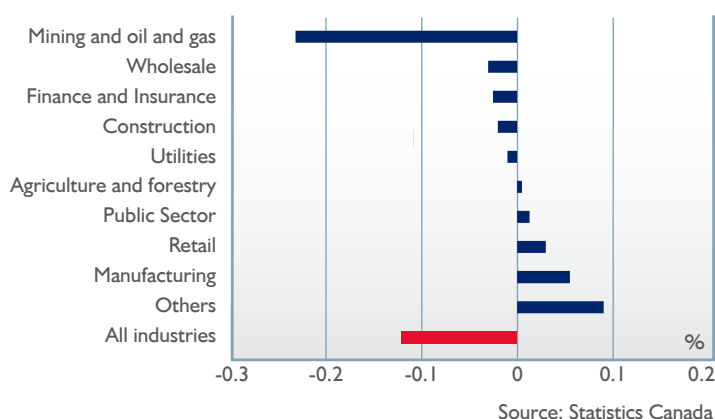
## CANADA

Production data indicate that the Canadian economy lost steam in the last quarter of 2011, and employment numbers point to this trend continuing in the first quarter of this year. These indicators seem to corroborate predictions that growth will slow in 2012. It also means that interest rates should stay low for a long time to come.

### Real GDP down slightly

Real GDP dipped slightly in November after staying steady the previous month. The decline was mainly due to a fall-off in oil and natural gas extraction (chart). The reduction in the crude oil sector was partly attributable to production stoppages for maintenance. In addition, the mild weather led to lower electricity production. Production was also down in the wholesale sector, finance and insurance sector, and construction. On the other hand, production increased in the manufacturing sector for the third consecutive month, and continued to climb in the retail sector for the fourth month in a row. The results for October and November indicate that the growth in production should be about 1.0% to 1.5% in the fourth quarter, which would bring the growth in 2011 to 2.3%, in line with Consensus forecasts.

### Main industrial sectors' contribution to the percent change in GDP, November 2011



### Forecast growth in real GDP in 2012 (in percentage)

	Issued	Canada	United States	Euro zone
Toronto Dominion Bank	December 2011	1,7	1,9	-1,2
Scotia Bank	January 2012	1,8	1,8	0,0
Laurentian Bank of Canada	January 2012	1,8	2,0	-1,5
Canadian Imperial Bank of Commerce	January 2012	2,0	2,1	-0,3
Bank of Montreal	January 2012	2,0	2,3	-1,0
National Bank of Canada	February 2012	2,0	2,5	-0,8
Royal Bank of Canada	January 2012	2,5	2,5	0,0
Consensus*	January 2012	2,0	2,2	-0,3

\* The Consensus forecasts are not an average of the other forecasts in the table; for Canada the Consensus includes forecasts from other Canadian financial institutions, and for the United States the figures come from American financial institutions.

### Employment up but only marginally

Only 2,300 jobs were created in January, as 5,900 part-time positions were added but 3,600 full-time jobs were lost. The unemployment rate edged up from 7.5% in December to 7.6% in January. The professional, scientific and technical services sector experienced the most losses, followed by finance, insurance and real estate, and construction. These losses were offset by gains in some other sectors, including educational services, trade and manufacturing. Regionally, Alberta saw the biggest change in job numbers in the last twelve months (+3.9%) while Quebec had the smallest (-1.7%). After losing just over 60,000 jobs in the last quarter of 2011, Quebec recovered 9,500 in January. Overall, the Canadian labour market, which had not taken long to recover the jobs lost during the recession, remained strong until mid-2011 but has been treading water since then. This could translate into a slowdown in consumer spending in the coming months.

### Trade balance improves

The trade balance switched from a \$487 million deficit in October to a \$1.1 billion surplus in November, due to a 3.2% increase in exports combined with a 0.8% drop in imports. Exports were up in most sectors, and the higher numbers were attributable equally to increases in prices (especially for energy products) and volumes (particularly for motor vehicles). The decline in imports was also attributable to both prices and volumes, and affected mainly automotive products and industrial goods. November's results more than offset the net decline in exports a month earlier and could point to good international trade results in the fourth quarter.

### Housing market still strong

The number of housing starts rose from 185,600 units in November to 200,200 in December. In urban areas, single family home starts were up 3.8% while multiple-unit housing starts jumped 14.5%. Canada Mortgage and Housing Corporation (CMHC) expects the number of starts to decline, due mainly to demographic changes, down from an estimated 191,000 ▼

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## Annual Change in Housing Starts and Existing Home Sales: Historical Data and Forecasts



starts in 2011 to 186,750 in 2012. According to the Canadian Real Estate Association, sales of existing homes were 1.8% higher in November than in December, and 2.2% higher in 2011 than in 2010. The CMHC expects sales of existing homes to rise slightly in 2012, by about 2.0%.

## Outlook for corporate profits rather gloomy

The Conference Board's Leading Indicator of Industry Profitability (LIIP) fell in December for the sixth straight month. The indicator declined in 21 of the 49 sectors. Stock market volatility, weak manufacturing activity in many sectors and deteriorating consumer confidence were some of the main factors accounting for these declines. However, many sectors posted encouraging results, especially those that benefit from low interest rates like construction, real estate, insurance, and scientific and professional services, which include engineering and architecture. ■

## ★ UNITED STATES

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The most recent data are encouraging. The uptick in employment is continuing and the housing market, although far from being out of the woods, posted some good results in recent months. Consumer confidence improved, then deteriorated again, showing that consumers are still anxious. If the labour market continues to improve, their confidence should firm up.

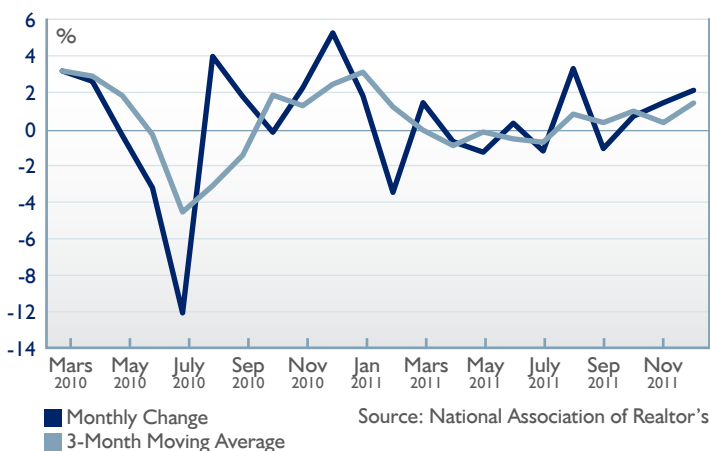
## Job creation continues

Non-farm employment grew by 243,000 jobs in January and the unemployment rate dropped to 8.3%. The private sector added 257,000 jobs in January. Despite this twenty-third consecutive monthly increase, the private sector has recovered only 40% of the jobs lost since 2008. If 200,000 jobs were created per month—which is the average for the last five months—it would take about two years to get employment back to the level it was at before the financial crisis, when the unemployment rate was around 5.0%. That being said, the results for recent months are very encouraging and give reason to hope that the U.S. economy is on the road to a sustainable recovery.

## Housing market recovery still fragile

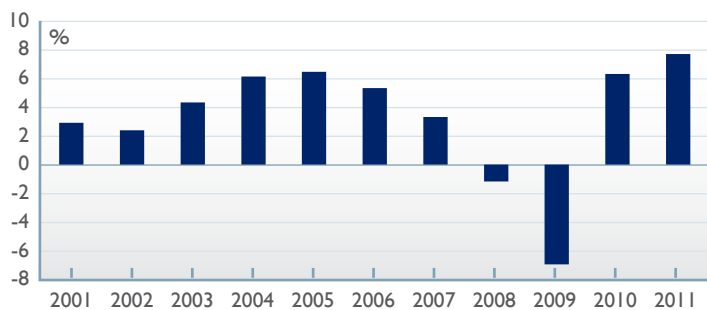
Housing starts in December were down 4.1% from the previous month. Multiple-unit housing starts plummeted 27.8% while single family home starts edged up 4.4%. This is the third consecutive monthly increase in single family home starts, which is very encouraging. In the real estate market, the National

## Existing Home Sales



Association of Realtors thinks that the recent rise in sales of existing homes (up 3.3% in November and 5.0% in December) could herald a sustainable recovery in the resale market (chart). The inventory of unsold homes was down significantly in December: at the current pace of sales it would take 6.2 months to clear the current inventory, compared to 7.2 months in November. However, although the inventory is getting closer to its normal level (about 5 months), it is too soon to celebrate because it will undoubtedly increase as homes seized by financial institutions are put back on the market. Also, the price of existing homes as measured by the S&P/Case-Shiller Home Price Index hit a new record low in November. ▼

## Retail Sales Growth



Source: U.S. Census Bureau

## Consumers still anxious

The U.S. Conference Board's Consumer Confidence Index, which had rebounded in November and December, fell back again in January—from 64.8 in December to 61.1 in January. Both components of the Index were down but the Present Situation Index fell more than the Expectations Index. The renewed confidence in the last months of the year had been expected to stimulate consumer spending, but retail sales were up only slightly at year-end. The decline in confidence in January does not augur well for the new year. That being said, for all of 2011, retail sales were 7.7% higher than in 2010, which is the best result in the past ten years (chart). ■

## INTEREST RATES

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### Key interest should remain low for a long time

It came as no surprise when the Bank of Canada left its key interest rate unchanged on January 17. The central bank, which recently updated its economic forecasts, is still expecting a slowdown in economic growth, from 2.4% in 2011 to 2.0% in 2012. Unused production capacity remains high and the

Bank does not think that the economy will get back up to full speed until third quarter 2013. This suggests that the key interest rate should stay at its current level for a long time to come. The majority of forecasters do not expect any increase in 2012, and some think it may be second quarter 2013 before we see a change. ■

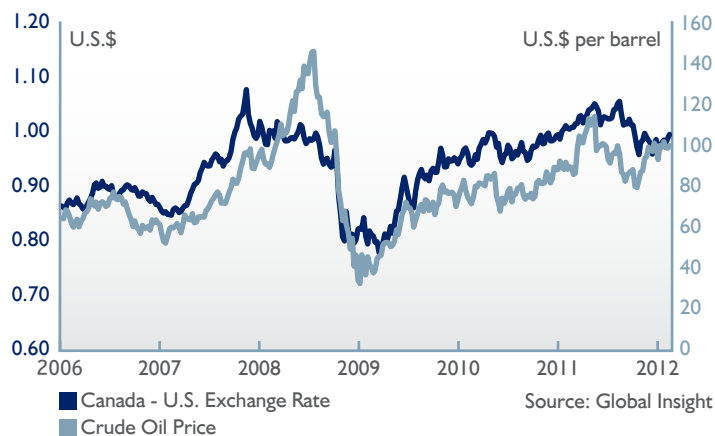
## OIL AND THE LOONIE

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### Price of oil remains high and Canadian dollar close to parity

The price of crude oil has been relatively stable since being buoyed by signs of improving economic conditions in the United States and hopes for a sustainable resolution of the sovereign debt crisis in Europe. In reaction to the European Union's decision to gradually impose an embargo on Iranian crude between now and July if Iran does not stop developing nuclear weapons, Iran threatened to immediately halt its exports to Europe, which would not leave the European countries time to find alternate supply sources. Although unlikely, because of Iran's dependence on oil revenues, this possibility helped keep the price of crude high. Meanwhile, the Canadian dollar has been stable in recent weeks. After climbing above the U.S. dollar, it has been slightly below parity since then. ■

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



Source: Global Insight

## Business confidence still stable

The CFIB's Business Barometer Index barely moved in January from the previous month (65.2 vs. 65.0). After falling significantly in August, when the sovereign debt crisis in Europe was at its height, the owners of small and medium-sized businesses gradually regained confidence. However, east-west regional differences remain: the indexes show that the four western provinces were above the national average, the Atlantic provinces were well below, while Ontario and Quebec were close to the mean. Entrepreneurs in the retail and hospitality sectors were the least optimistic, while the most upbeat were in the natural resources, finance, insurance and real estate, and wholesale sectors. ■

## CFIB Business Barometer and Real GDP Growth (Index of 50 = equal balance of stronger and weaker business expectations)



# BUSINESS CREDIT CONDITIONS

## End of easing in business credit conditions

According to the Senior Loan Officer Survey, after several quarters of easing, business credit conditions were virtually unchanged in the last quarter of 2011, while the results of the Business Outlook Survey indicated a slight net tightening. According to the latter survey, in the past three months medium-sized and large firms and those that source financing from capital markets encountered higher borrowing costs. ■

## Business Credit Conditions (Balance of opinions %)





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	3.5	-0.5	3.5		Nov	-0.1	2.3	2.0
Machinery and Equipment Expenditures (% growth)	4.2	-0.5	-19.5	11.8	14.5	32.7	-11.0				14.5	5.9
Pre-Tax Corporate Profits (% growth)	1.9	11.0	-33.1	21.2	20.5	-7.8	18.1				13.9	4.8
Industrial Production (% growth)	-0.5	-3.1	-9.5	4.9	7.2	-4.2	7.5		Nov	-0.8	3.1	2.9
Industrial Product Prices (% growth)	1.5	4.3	-3.5	1.0	9.6	5.4	-0.1	1.2	Dec	-0.7	3.6	2.2
Non-Residential Construction (% growth)	2.3	7.9	-22.2	2.8	10.3	-0.9	4.4					
Housing Starts (' 000 units)	229	212	148	191	177	192	205	199	Dec	200	191	179
Personal Expenditures (% growth)	4.6	3.0	0.4	3.3	-0.1	2.1	1.2				1.9	1.9
Consumer Price (% growth)	2.1	2.4	0.3	1.8	3.6	3.1	1.1	2.9	Dec	-0.6	2.9	2.0
Employment (% growth)	2.4	1.7	-1.6	1.4	2.2	1.6	1.2	-0.3	Jan	0.0		
Unemployment Rate (%)	6.0	6.1	8.3	8.0	7.7	7.5	7.3	7.5	Jan	7.6	7.5	7.4
SMEs Confidence Index (CFIB)	67.2	56.1	57.7	66.7	69.2	68.0	64.2	64.1	Jan	65.2		
Manufacturers Confidence Index (CFIB)	68.8	52.7	56.0	68.6	72.6	71.0	63.5	61.8	Jan	61.7		

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