

CANADA ECONOMIC OUTLOOK

Q1 2011



23rd Feb. 2011

Housing downturn to hit economic growth

- **Overview** – Because Canada emerged from the global financial crisis largely unaffected, many Canadians now appear to believe that the economy is somehow invincible. This level of hubris is disconcerting when housing valuations have lost all touch with the fundamentals, driven up by a massive surge in household debt. We've seen this story played out in countless other countries and it never has a happy ending. The now inevitable downturn in the housing sector will severely constrain economic growth over the next couple of years, as consumption expands at a more muted pace and housing investment shrinks back towards a more normal size (Pages 3 & 4.)
- **Domestic Demand** – Consumption spending will lag real personal disposable income, as the housing downturn forces households to lift their lacklustre saving rate. We also anticipate that the end of the housing boom will lead to a marked decline in housing-related activity and employment. Employment gains will be modest this year and will slow as the economic recovery loses momentum next year. As a result, the unemployment rate will gradually rise this year and next.
- Business investment growth will remain solid, as businesses attend to worn-out capital equipment from the long recession and because of the need to improve the productivity of their labour work force. (Pages 5 & 6.)
- **External Demand** – A pick-up in external demand will help to buffer export growth this year, but the strong Canadian dollar and the composition of domestic demand and its propensity to import will mean that net exports will continue to be a drag on the economy. (Pages 7 & 8.)
- **Prices** – The past run-up in crude oil and agricultural prices will lead to higher headline inflation later this year. However, this will prove to be temporary, as we expect commodity prices to fall in 2012. Underlying inflation this year and next will remain subdued. (Pages 9 & 10.)
- **Monetary & Fiscal Policy** – Underlying pressures affecting prices will remain subdued and inflation expectations remain well anchored. Financial risks abroad and at home are elevated, making the economic outlook unusually uncertain. Under those circumstances, we do not expect the Bank of Canada to risk jeopardising the economic recovery by raising interest rates. (Pages 11 & 12.)

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Forecasts

%q/q annualised (unless otherwise stated)	2010				2011				2012				Annual (%y/y)		
	Q1	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	2010f	2011f	2012f
Demand															
GDP	5.6	2.3	1.0	2.7	2.1	2.0	1.7	1.3	1.0	0.8	0.7	0.7	3.0	2.0	1.0
Consumption	4.1	2.3	3.5	2.7	1.3	1.3	1.2	1.1	0.9	0.8	0.7	0.7	3.4	1.9	1.0
Private Fixed Investment	15.0	10.0	9.0	5.0	3.0	4.0	4.0	3.0	3.0	2.0	2.0	2.0	7.0	5.0	3.0
- Business Investment	11.0	16.0	20.0	9.0	9.0	8.0	8.0	7.0	7.0	5.0	5.0	5.0	5.0	10.0	6.0
- Machinery & Equipment	18.0	33.0	29.0	15.0	15.0	13.0	13.0	10.0	10.0	8.0	8.0	8.0	14.0	16.0	10.0
- Non-Residential Structures	5.0	1.0	11.0	3.0	3.0	3.0	3.0	3.0	3.0	2.0	2.0	2.0	-3.0	4.0	3.0
- Residential Investment	20.0	1.0	-5.0	0.0	-6.0	-3.0	-2.0	-3.0	-4.0	-4.0	-4.0	-4.0	10.0	-3.0	-3.0
Government Expenditure	1.3	2.7	0.9	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	3.2	1.5	1.5
Stockbuilding (Change, C\$bn)	5	15	18	-2	1	4	5	6	7	8	8	8	9	4	8
Domestic Demand	7.0	7.7	5.1	-3.1	3.0	2.7	2.5	2.0	1.8	1.5	1.4	1.4	5.5	2.2	1.9
Exports	10.1	5.6	-5.0	23.9	4.7	4.6	3.5	2.3	1.0	0.5	0.8	0.7	6.8	6.5	1.6
Imports	13.2	19.8	6.4	2.7	6.3	5.8	5.1	3.9	3.0	2.4	2.4	2.3	13.3	6.0	3.4
Labour Market															
Unemployment Rate (%)	8.2	8.0	8.0	7.7	7.8	8.3	8.3	8.3	8.5	8.6	8.8	8.9	8.0	8.2	8.7
Employment (Av. Mthly Change, 000s)	21	47	19	6	33	15	13	10	5	5	5	5	19	20	5
Labour Productivity	0.9	-2.6	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	0.8	0.8	1.0
Income & Saving															
Real Personal Disposable Income	3.1	15.1	-7.7	1.4	2.7	1.9	0.8	1.5	2.0	1.8	1.7	1.6	2.8	1.4	1.6
Saving Rate (As a % of Disposable Inc.)	3.3	6.1	3.3	3.0	3.4	3.5	3.4	3.5	3.8	4.0	4.2	4.4	3.9	3.5	4.1
Prices (%y/y)															
Consumer Prices	1.6	1.4	1.8	2.3	2.3	2.8	2.9	2.6	2.5	2.4	2.2	2.0	1.8	2.6	2.3
Core Consumer Prices ¹	2.0	1.8	1.5	1.6	1.6	1.6	1.6	1.7	1.7	1.7	1.7	1.7	1.7	1.6	1.7
Markets (end period)															
Overnight Target Rate (%)	0.25	0.50	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
10 Year Treasury Yield (%)	3.50	3.30	2.90	3.20	3.10	3.00	2.90	2.80	2.70	2.70	2.60	2.60	3.20	2.80	2.60
USDCAD Exchange Rate	0.96	0.97	0.96	0.99	1.01	1.01	1.00	0.99	0.98	0.97	0.96	0.94	0.99	0.99	0.94
Other															
Trade Balance (C\$bn)	-16	-30	-48	-24	-24	-30	-37	-45	-55	-66	-79	-95	-30	-34	-74
General Gov't Balance (As a % of GDP)	-4.2	-5.9	-5.2	-4.7	-4.4	-4.1	-3.8	-3.6	-3.4	-3.2	-3.1	-2.9	-5.0	-4.0	-3.1
Current Account (As a % of GDP)	-2.3	-3.2	-4.3	-3.0	-3.0	-3.2	-3.6	-3.9	-4.4	-4.9	-5.6	-6.3	-3.2	-3.4	-5.3

¹ Bank of Canada Core Inflation.

Overview

Housing downturn to hit economic growth

- The now inevitable downturn in the housing sector will severely constrain economic growth over the next couple of years, as consumption expands at a more muted pace and housing investment shrinks back towards a more normal size. Economic growth will rely increasingly on business investment and net exports (See Chart 1.)
- Over the last several years, growth in consumption has far outstripped income gains, as households have gone on a spending binge, funded by credit growth and home equity extraction. (See Chart 2.)
- With household balance sheets stretched and house prices expected to fall, however, we forecast that growth in consumption spending will lag income growth for the next couple of years, as households focus on rebuilding their saving rate.
- House prices have been growing rapidly for nearly a decade now (see Chart 3,) and it has reached the point where housing is so over-valued relative to incomes that a downward correction seems unavoidable. We fear that house prices could fall by as much as 25% over the next three years.
- Canada's economy has grown overly-reliant on the housing sector in recent years, so any drop back in prices could lead to a sizeable contraction in housing investment, which is currently well above its historical average. (See Chart 4.) In the aftermath of previous housing booms, housing investment has fallen by roughly 2.5% of GDP.
- In contrast, business investment looks unusually depressed, leaving considerable scope for stronger growth, particularly in spending on machinery and equipment. (See Chart 5.)
- The correlation between US economic growth and Canada's exports is fairly high. As such, stronger US economic growth this year will provide some relief to Canada's exporters. However, as the US recovery loses momentum in 2012, growth in exports will slow once again. (See Chart 6.)
- While high energy and food prices keep headline inflation elevated this year, we anticipate that excess capacity, persistently high unemployment, and little in the way of wage pressures will contain underlying inflation. (See Chart 7.)
- The economic outlook remains unusually uncertain. The upside risks to our outlook are stronger than anticipated US economic growth and higher commodity prices, which would lift Canadian exports and incomes. The biggest downside risk is that an adverse feedback loop could develop, as it did in the US, with rapidly falling house prices leading to a contraction in both output and employment, which puts even more downward pressure on house prices.
- Given our outlook for economic growth and underlying (core) inflation, we doubt that the Bank of Canada will risk removing any monetary stimulus. By year end, we expect the overnight policy rate to be still at 1%. (See Chart 8.)

Overview Charts

Chart 1: Annual Contributions to GDP Growth (%)

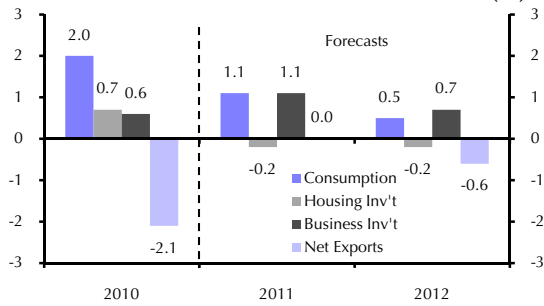


Chart 2: Household Spending & Financial Leverage

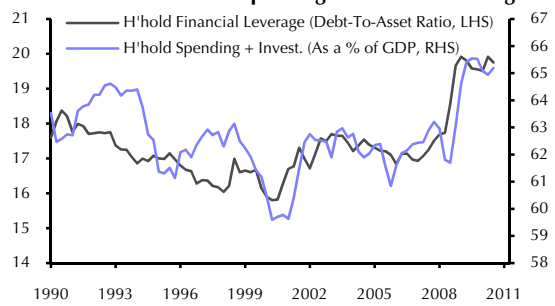


Chart 3: House Prices (%/y/y)

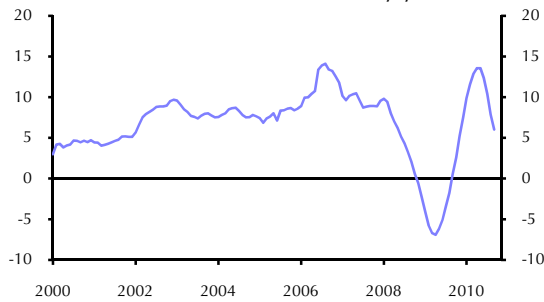


Chart 4: Housing Investment (As a % of GDP)

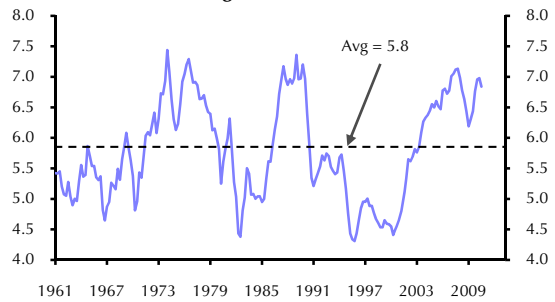


Chart 5: Business Investment (As a % of GDP)

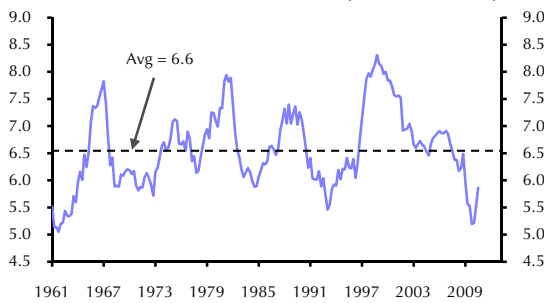


Chart 6: US GDP & Canada's Total Exports (%/q Ann.)

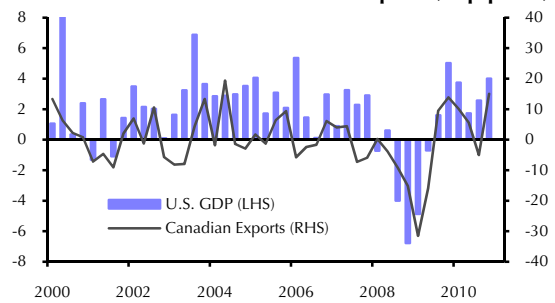


Chart 7: Inflation Outlook (%)

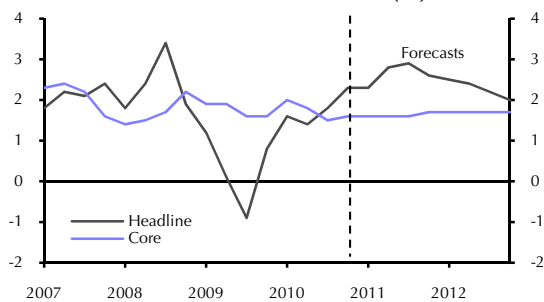
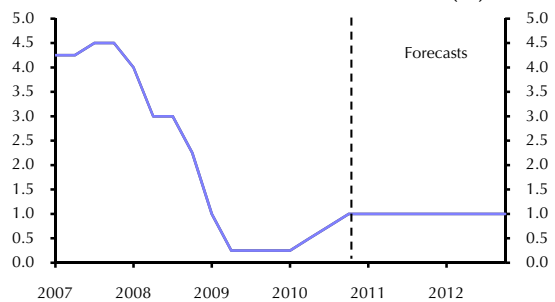


Chart 8: Bank of Canada Interest Rate (%)



Sources – Thomson Datastream & Capital Economics

Domestic Demand

Household spending set to slow

- Because Canada emerged from the global financial crisis largely unaffected, many Canadians now appear to believe that the economy is somehow invincible. This level of hubris is disconcerting when housing valuations have lost all touch with the fundamentals, driven up by a massive surge in household debt. We've seen this story played out in countless other countries and it never has a happy ending.
- Relative to incomes, our calculations suggest that Canadian housing is now just under 40% over-valued, which is about the same level of excess that the US market reached before it collapsed. (See Chart 1.) We have pencilled in a 25% cumulative decline in house prices over three years, mirroring what happened south of the border.
- Canadian household debt is now up to 150% of disposable income, well in excess of what we saw in the US. (See Chart 2.) Admittedly, low interest rates mean the servicing costs on that debt are not currently excessive.
- Since real estate (structures and land) accounts for slightly more than one third of household assets, substantial declines in house prices would hit household net worth hard, prompting households to raise their saving rate. (See Chart 3.)
- Rebuilding that saving rate will require a marked slowdown in consumption growth. (See Chart 4.) Admittedly, the recent strength in employment growth together with some modest improvement in average hours worked suggests that some of the expected rebound in the saving rate could be achieved through stronger income growth. (See Chart 5.) Unfortunately, the end of the housing boom will have a serious detrimental impact on total employment and housing activity as well as asset values.
- As we noted earlier, the housing sector has become tremendously bloated during the boom. Construction now accounts for 7% of overall employment. (See Chart 6.) Even without big declines in house prices, we would expect that share to shrink back to its long-term average of about 5.5%, which would involve the loss of 250,000 jobs.
- Housing investment will shrink as a share of GDP too, with the expected contraction in home renovation alone reducing GDP by 1%.
- The growth rate of business investment will slow a little from the red hot pace in the second half of 2010. We nevertheless expect another strong performance in 2011, as Canadian firms take advantage of low borrowing costs, a strong currency, and growing profits, particularly in the natural resources sector. (See Chart 7.)
- That additional investment should ensure a relatively decent productivity performance, at least for Canada. (See Chart 8.) We expect productivity to grow by 1% per year over the next couple of years.
- Overall, we anticipate that domestic demand growth will slow from 5.5% in 2010, to 2.2% in 2011 and only 1.9% in 2012.

Domestic Demand Charts

Chart 1: House Price to Income Per Employee (Ave. = 100)

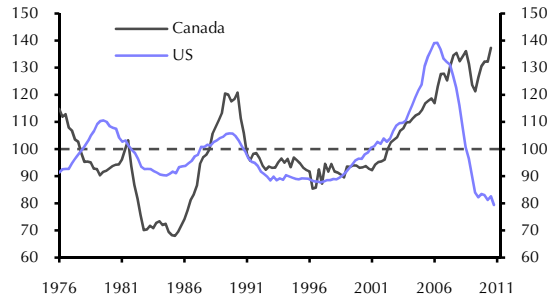


Chart 2: Household Debt (As a % of Disposable Income)

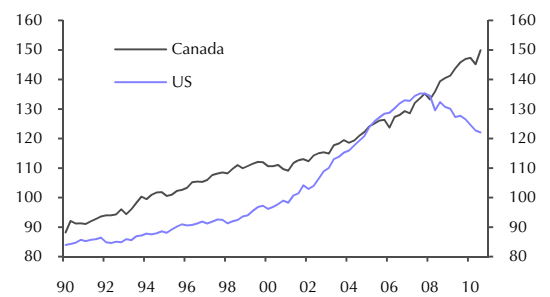


Chart 3: Net Worth & Saving Rate (As a % of Disp. Income)

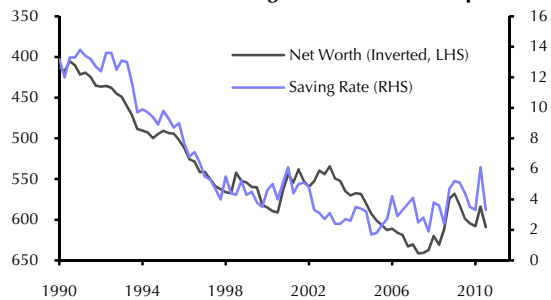


Chart 4: Consumption (%q/q Ann.)

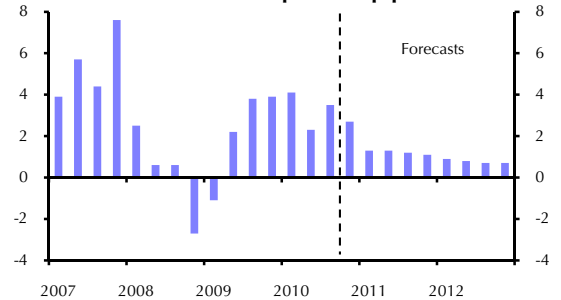


Chart 5: Monthly Change in Employment (000s)

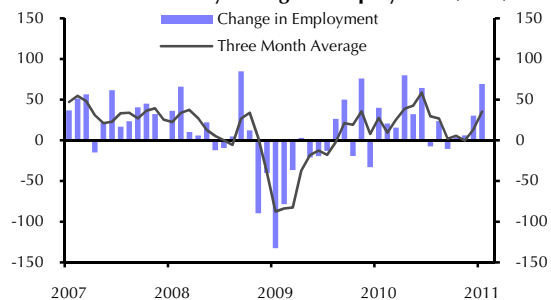


Chart 6: Impact of Housing on Activity

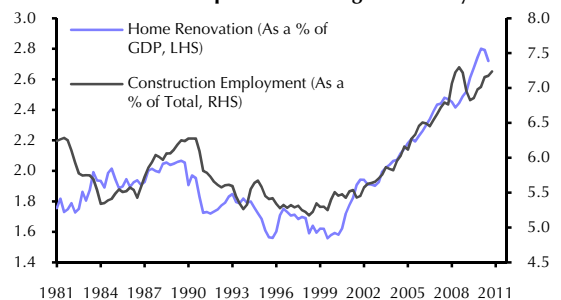


Chart 7: Business Investment in Machinery & Equipment

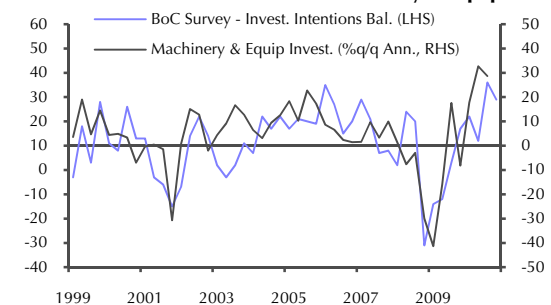
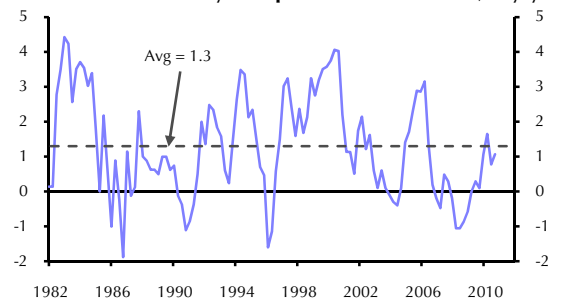


Chart 8: Productivity (Output Per Hour Worked, %y/y)



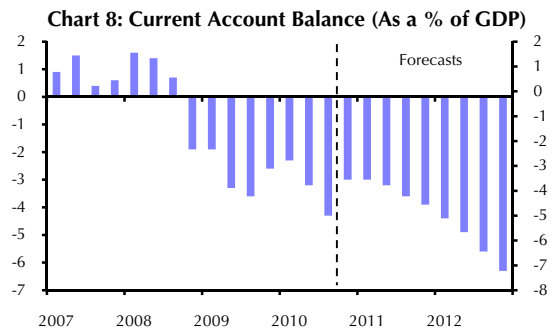
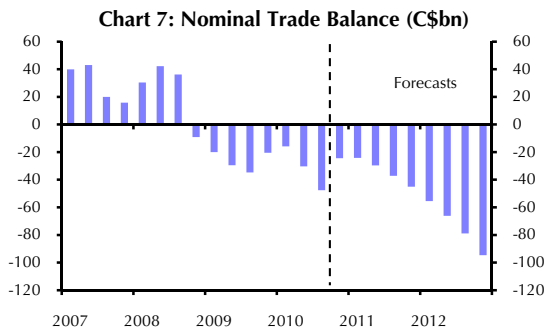
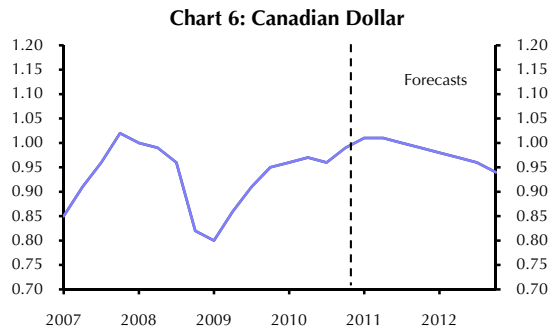
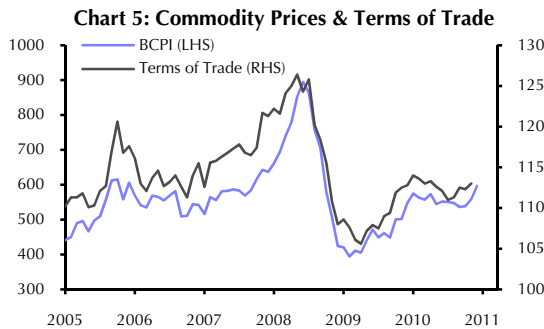
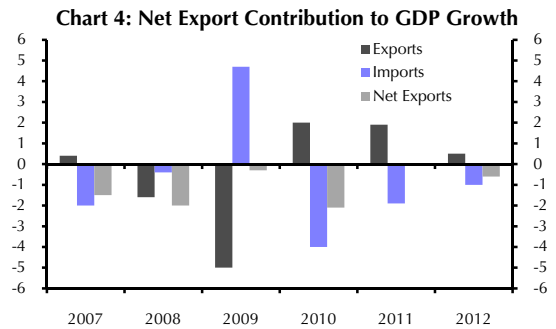
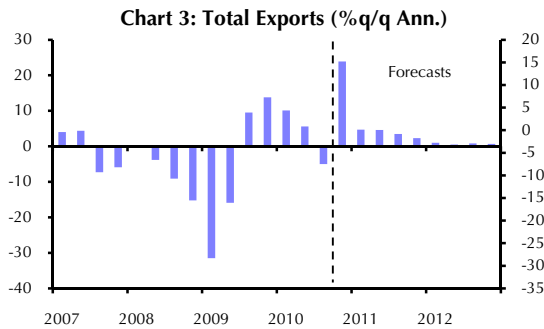
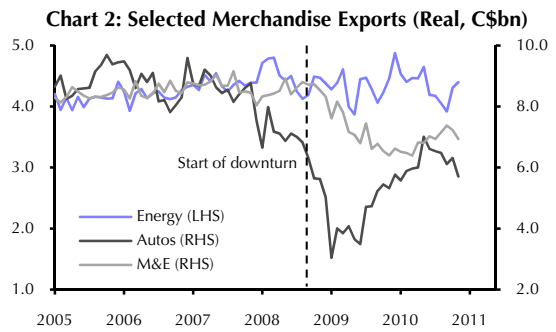
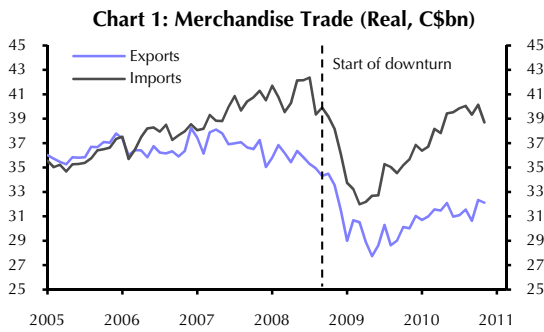
Sources – Thomson Datastream & Capital Economics

External Demand

Net exports to remain a drag on growth

- At the onset of the global recession, exports and imports plummeted simultaneously reaching a trough in early 2009. Since then, trade has gradually improved, though the rebound in exports has been hindered by the sluggish recovery in the US and the strong Canadian dollar. (See Chart 1.)
- The export recovery has not been broad-based. While energy and other commodity-related exports have held up quite well, exports of autos, machinery and equipment, and also forestry products have languished. (See Chart 2.)
- Much of the weakness in auto and forestry related exports are due to the constraints on household credit and structural problems in the US housing market. These structural factors affect the composition of US demand, which will have additional unfavourable implications for Canadian export growth this year and next.
- We estimate that Canada's total exports will advance at a modest pace this year, averaging growth of close to 5% in 2011. (See Chart 3.)
- Next year will be a different story, as the US economic expansion loses momentum, once the latest round of policy stimulus fades. If we are correct, Canada's overall export performance in 2012 will be much worse than in 2011. (See Chart 3.)
- While our outlook for exports adds to economic growth in 2011 and (barely) in 2012, it will simply be too weak to offset fully the negative contribution from total imports. Consequently, we see no end to the drag from net exports on GDP growth, which also means a further widening of Canada's already large real trade deficit. (See Chart 4.)
- High crude oil and non-energy commodity prices, together with a strong Canadian dollar, are expected to support Canada's terms of trade in 2011. (See Chart 5.)
- Nevertheless, we predict that the price of (WTI) crude oil will end 2012 at closer to US\$ 70 per barrel, well below its current trading price of around US\$ 90 per barrel. We expect non-commodity prices to fall back too. These declines will also lead to depreciation of the Canadian dollar, from just above parity now to US\$0.94 by end-2012. (See Chart 6.)
- Our outlook for real trade flows and the terms of trade suggests that Canada's nominal trade deficit will narrow somewhat this year, before widening substantially after that. By the end of 2012, it is quite plausible that Canada's trade deficit could exceed C\$100 billion, almost double what it was in the third quarter of 2010. (See Chart 7.)
- There will be a corresponding widening of the overall current account deficit as well. Expressed as a percentage of nominal GDP, the current account is expected to remain close to 4% in 2010, before widening to almost 6.5% by the end of 2012. (See Chart 8.)

External Demand Charts



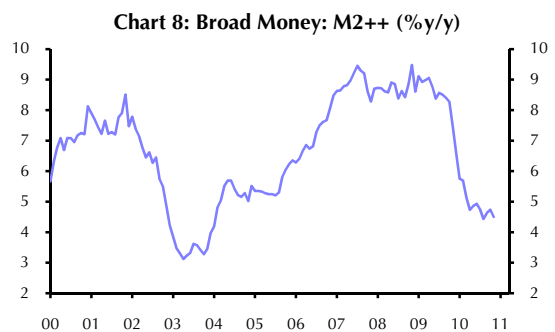
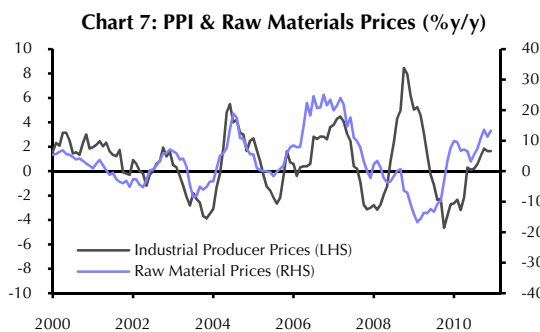
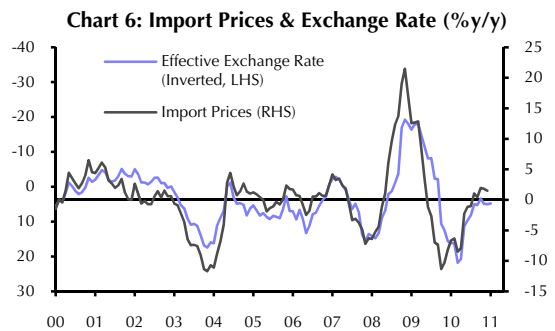
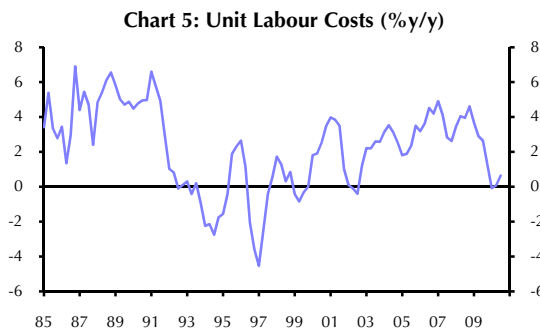
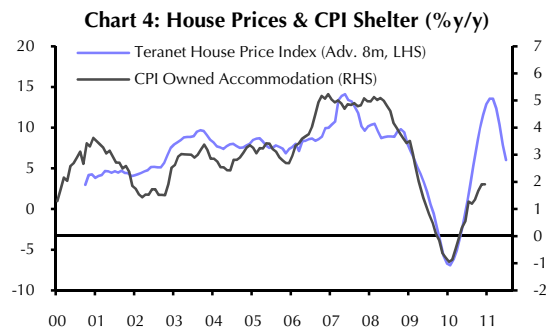
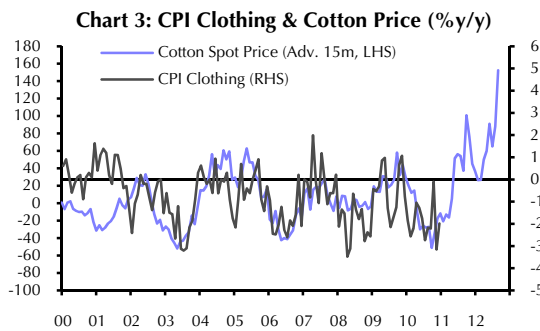
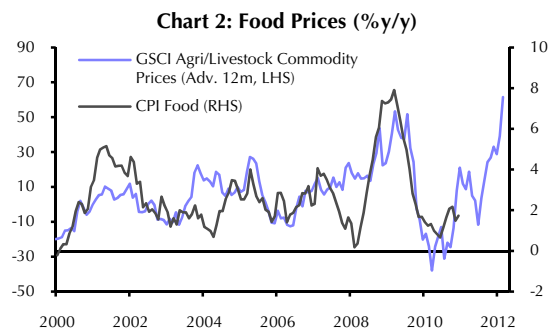
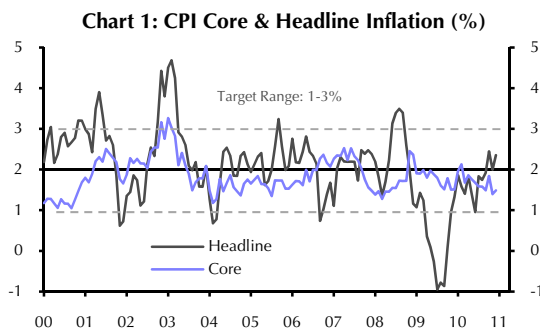
Sources – Thomson Datastream & Capital Economics

Prices

Headline inflation boosted by commodity price surge

- The most recent pick up in headline consumer price inflation mainly reflects the rise in energy prices. (See Chart 1.) We anticipate an even more marked increase in headline inflation over the next few months, however, as the massive surge in agricultural commodity prices begins to feed through. (See Chart 2.)
- The headline inflation rate will accelerate to about 3% by mid-year. Nevertheless, with wage growth slowing and excess supply limiting potential price increases, we expect underlying inflation to remain muted.
- The rapid appreciation in world agricultural prices will have a substantial impact on CPI food inflation. Given the typical lags in the range of six to 12 months, we expect food inflation to rise from below 2% now to 6% or above later this year. (See Chart 2.)
- Core inflation will be more insulated from the impact of surging commodity prices, but it won't be completely exempt. In particular, the recent surge in cotton prices will lead to a marked pick up in retail clothing prices. (See Chart 3.)
- Nevertheless, there are a few reasons to suspect that the rise in inflation won't get out of control. The current headline CPI inflation rate still includes the impact of the sales tax rises in Ontario, British Columbia, and Nova Scotia in mid-2010. Once those hikes drop out of the annual growth rate in mid-2011, it will take about 0.4% off headline inflation.
- More importantly, even a slowdown in house price inflation, let alone the outright decline that we anticipate, would be enough to reduce the growth rate of housing costs in the CPI. (See Chart 4.) The muted pace of unit labour cost growth also points to low underlying inflation. (See Chart 5.)
- Canadian dollar appreciation has helped to keep import prices down, contributing towards low underlying inflation. This will continue in 2011, but some depreciation of the Canadian dollar in 2012 could add to import price inflation. (See Chart 6.)
- Although raw material input and producer output prices are rising, there has so far been little impact on consumer prices. While it may be too early to tell given the lags, we think excess industry capacity and competitive pressures are limiting the ability of many manufacturers to pass-through rising costs to consumer prices. (See Chart 7.)
- Another key indicator of longer-term inflation is growth in the broad money supply. Growth in the broadest measure in Canada (M2++) has slowed considerably in recent months. (See Chart 8.)
- The biggest upside risks to our inflation outlook are that commodity prices continue to rise or that the increases we have seen so far generate second-round effects, pushing up wages and the price of other goods and services.
- On the down side, the biggest risk is that commodity prices drop back more sharply than we expect, which could temporarily push inflation below zero.

Prices Charts



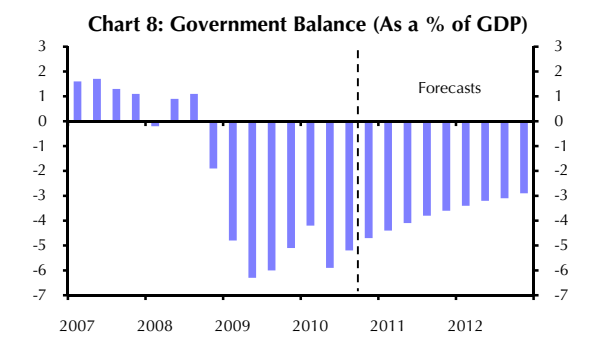
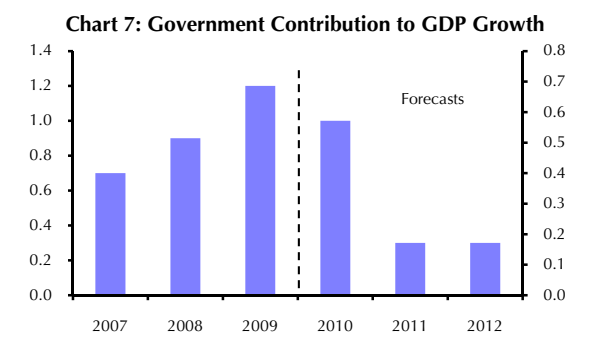
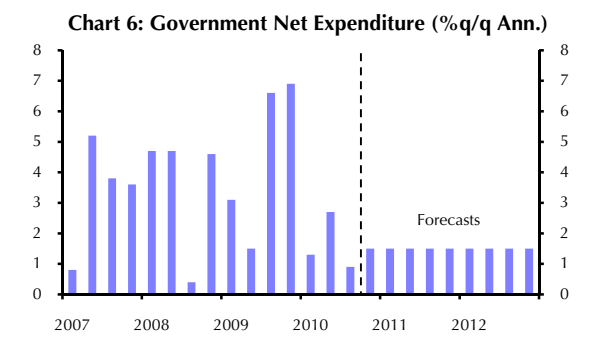
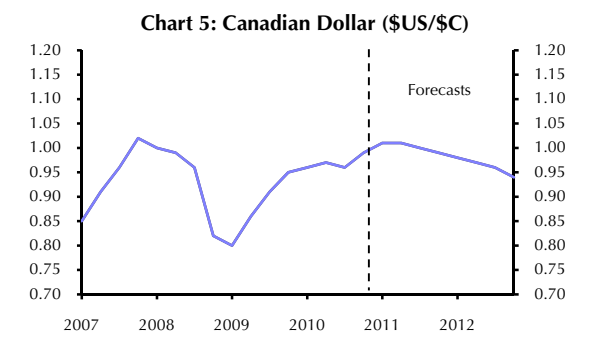
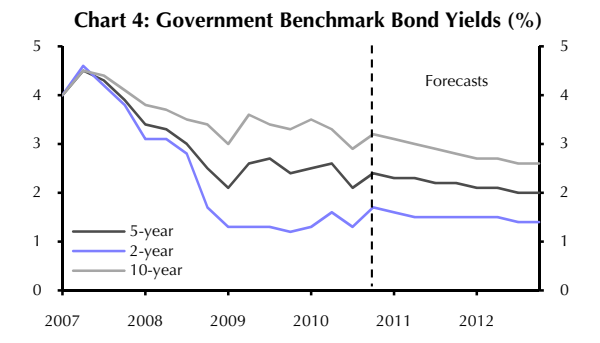
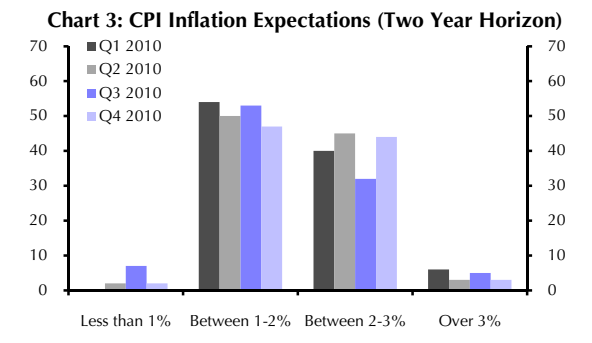
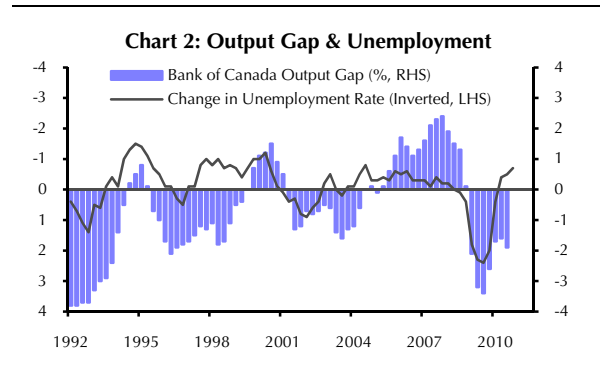
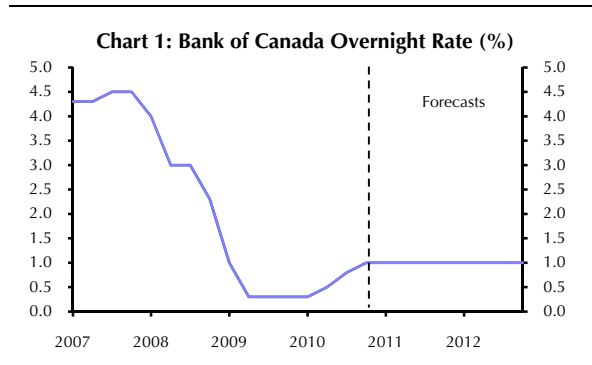
Sources – Thomson Datastream & Capital Economics

Monetary & Fiscal Policy

Monetary policy on hold while fiscal stimulus fades

- In 2010, the Bank of Canada unwound the last of its exceptional liquidity measures and raised the overnight rate from 0.25% on June 1st of last year to 1.00% on September 8th. (See Chart 1.)
- Since that time, however, the Bank has balked at tightening policy further, for fear of jeopardising Canada's increasingly fragile economic recovery. The Bank's recent policy statements have put most weight on excess capacity, high unemployment, and the various financial downside risks to economic growth and projected inflation. (See Chart 2.)
- Despite better economic data over the last few months, the Bank has not materially changed its outlook for Canada's economic growth and inflation. Aside from the elevated financial risks it mentioned (both home and abroad), the Bank is deeply concerned about the strong Canadian dollar, net exports, and the historically large current account deficit.
- Not only are measures of underlying inflation subdued, inflation expectations are well anchored. According to the Business Outlook Survey, expectations remain well within the 1% to 3% target range. (See Chart 3.)
- For all these reasons, we think the Bank of Canada will not be in any rush to remove further monetary stimulus. As such, we predict that the Bank will hold the overnight policy rate at 1% this year, and the same in 2012.
- The market consensus has priced in two - quarter-point policy rate increases this year. We think this is too high. If we are right, we would expect longer-term government benchmark bond yields to gradually drift lower again. (See Chart 4.)
- Given the tightening bias priced into the market and the upward momentum in commodity prices, the Canadian dollar is expected to tread around par with the US dollar for most of this year. Next year will be a different story, however, as tumbling commodity prices and further postponement of interest rate increases lead to depreciation of the Canadian dollar. (See Chart 5.)
- Federal and Provincial budget deficits point to considerable spending restraint in the years ahead, some of which will be achieved through public sector jobs cuts. We anticipate that growth in real net government expenditure will be substantially reduced, with annual average growth of 1.5% in 2011 and 2012. (See Chart 6.)
- Government capital investment will also begin to ease this year and in 2012. Taken together, government spending and capital investment will contribute very little to real GDP growth, in stark contrast to previous few years. (See Chart 7.)
- We expect the general government balance to gradually decline over the forecast horizon, from around -5.0% in 2010 to -4.0% in 2011 and -3.0% in 2012. (See Chart 8.)

Monetary & Fiscal Policy Charts



Sources – Thomson Datastream, Bank of Canada & Capital Economics