THE CANADIAN CHAMBER OF COMMERCE
LA CHAMBRE DE COMMERCE DU CANADA

Economic Outlook 2010: On The Road To Recovery

Policy Brief

Economic Policy Series – December 2009

Introduction

The global economy is transitioning from recession to recovery. The recovery is spurred by the unprecedented actions of policymakers around the world to stabilize the global financial system, unfreeze credit markets and restore credit flows. Their extraordinary efforts have resulted in a marked improvement in global financial conditions. Additionally, massive fiscal stimulus is providing the global economy with much needed traction.

Global trade volume has stabilized, share prices have rebounded, commodity price indices are trending up, consumer and business confidence is gradually returning worldwide, and there are signs of stabilization in the distressed U.S. and UK housing markets.

The economic climate improved in all major economic regions in the fourth quarter,[1] but economic performance varies widely among regions Emerging-market economies, China and

1 See International Chamber of Commerce (ICC) and Ifo Institute for Economic Research. "Clear Improvement in the Ifo World Economic Climate." *Press Release.* November 19, 2009.

The Canadian Chamber is committed to fostering a strong, competitive, and profitable economic environment that benefits all Canadians. This paper is one of a series of independent research reports covering key public policy issues facing Canada today.

We hope this analysis will raise public understanding and help decision-makers make informed choices. The papers are designed not to recommend specific policy solutions, but to stimulate public discussion and debate about the nation's challenges.

India in particular, have returned to remarkably high growth rates (8.9 percent and 7.9 percent, respectively in the third quarter). Other emerging economies hit hard by the financial crisis, especially those in Eastern Europe, are still struggling. All G7-member nations have pulled out recession with the exception of the UK. Latin American countries are experiencing uneven patterns of economic activity.

While large economic contractions have usually been followed by robust economic expansions, the pace of renewed global activity will be much slower this time around reflecting the deep and lasting damage caused by the financial crisis. On a global basis, $50 trillion dollars in wealth evaporated between the fourth quarter 2007 and the first quarter 2009,[2] and some 40 million people have lost their jobs.[3] Inevitably, this has led to declining demand worldwide.

Overall, the International Monetary Fund (IMF) projects the global economy will grow 3.1 percent in 2010.[4] This is moderate by historical standards.[5] The IMF predicts emerging-market economies will contribute 70 percent to the growth of global economy in 2010, compared to 30 percent for advanced economies.

For the Canadian economy, the implications are significant. Canadian exporters will face constrained demand for their goods and services in traditional export markets – the U.S. (where 73 percent of Canadian merchandise exports are destined), and the European Community (where nine percent of Canadian exports are destined). Domestic demand will be the main engine of growth in 2010.

Overall, the Canadian economy is projected to grow at a modest pace (2.6 percent, year-over-year) in 2010 before ramping up to 3.3 percent in 2011. As with all forecasts, ours are subject to inherent risks and uncertainties which are so prevalent.

2 Remarks by Lawrence H. Summers, Director of the National Economic Council. “Responding to an Historic Economic Crisis: The Obama Program.” Brookings Institution. Washington, DC. March 13, 2009.

3 International Labour Organization (a specialized agency of the United Nations). “ILO says job losses are increasing due to economic crisis.” *Press Release*. May 28, 2009.

4 International Monetary Fund. “World Economic Outlook: Sustaining the Recovery.” October 2009. The IMF predicts growth of 5.1 percent for emerging and developing economies as a whole, and 1.3 percent for advanced economies.

5 Global GDP growth averaged about 5.0 percent per year from 2004 to 2007. Its long-run average is 3.7 percent.

Economic Growth Resumes In Canada After Three Consecutive Quarterly Declines

Canada's economy emerged from recession, posting a 0.4 percent annualized gain in the third quarter. While this did not set off any fireworks, it is the first quarter of positive growth in a year. Growth was underpinned by very strong domestic demand (consumer spending, residential investment, government expenditures and business investment). Canadian consumers are regaining the confidence to spend thanks to household net wealth advancing after losing ground in three consecutive quarters, and the job market recovering with 94,000 net new jobs created since the beginning of August. Auto and home sales registered gains in the quarter with low borrowing costs underpinning affordability. In particular, national housing sales have surged to record highs (albeit rebounding from extremely low levels), and home prices have rebounded forcefully. Business confidence has also improved. Firms invested heavily in machinery and equipment (M&E) as the strong Canadian dollar cut the cost of imported capital. Lastly, a large dose of fiscal stimulus helped pull the Canadian economy out of recession.

The major weak spot in the third quarter was a significant deterioration in the trade balance. Imports surged 36.0 percent, more than double the 15.3 percent increase in exports. As a result, net exports shaved 5.3 percentage points from the quarterly growth rate in GDP. However, the details were more positive. Businesses imported significantly more machinery and equipment which bodes well for future productivity, and exports did advance, the first quarterly gain in over two years.

2010: Continued Growth, Albeit At A Modest Pace.

After a tepid start to the recovery, economic momentum is expected to gradually build in 2010 buttressed by domestic demand. Low interest rates and sizable fiscal stimulus – about $25 billion in 2010 – will stoke the recovery. G20 Leaders, including Canada's, have committed to maintain stimulus until the recovery is assured.

$ Billions	2009	2010
Total Federal Stimulus Measures	$ 27.9	$ 19.3
Assumed Provincial and Territorial Actions	$ 8.6	$ 6.1
Total Stimulus	$ 36.5	$ 25.4

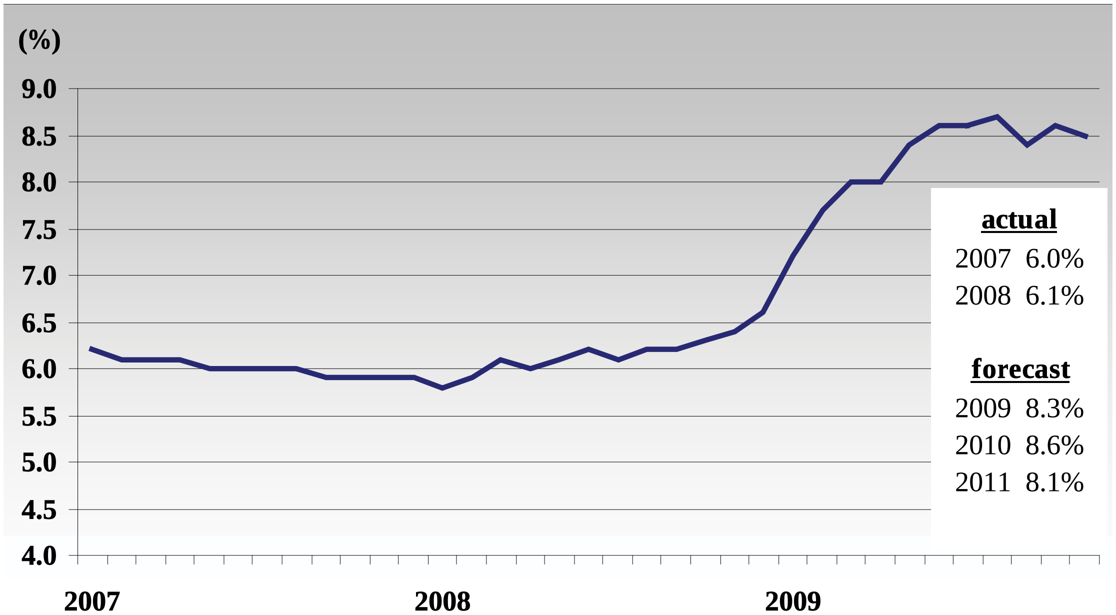
Source: Government of Canada. "Canada's Economic Action Plan - Fourth Report to Canadians." December 2009.

Net trade will continue to drag on recovery as growth in imports outpaces that of exports. All in, the Canadian economy is anticipated to grow about 2.6 percent in 2010 after contracting by an estimated 2.5 percent in 2009. This performance is fairly modest compared to the average of previous economic cycles reflecting a number of factors:

- **Consumer Spending:** Consumers will continue to spend, but cautiously. The unemployment rate is expected to peak in early 2010 at about 8.8 percent as previously discouraged workers re-enter the labour force and resume job searches. Hiring intentions have improved, but employers remain guarded. As a result, the unemployment rate is expected to remain well above pre-recession levels, and gains in real personal disposable income are likely to be modest. Additionally, the personal saving rate is anticipated to stay at elevated levels over the next couple of years as households focus on strengthening their balance sheets.[6] This too will constrain spending.

6 The personal saving rate is defined as savings as a percentage of personal disposable income. It has risen from 1.9 percent in the final quarter of 2007 to 5.5 percent in the second quarter of 2009. In the third quarter it dipped to 4.8 percent. In 2010 and 2011, it is expected to average about 5 percent.

Unemployment Rate (%)

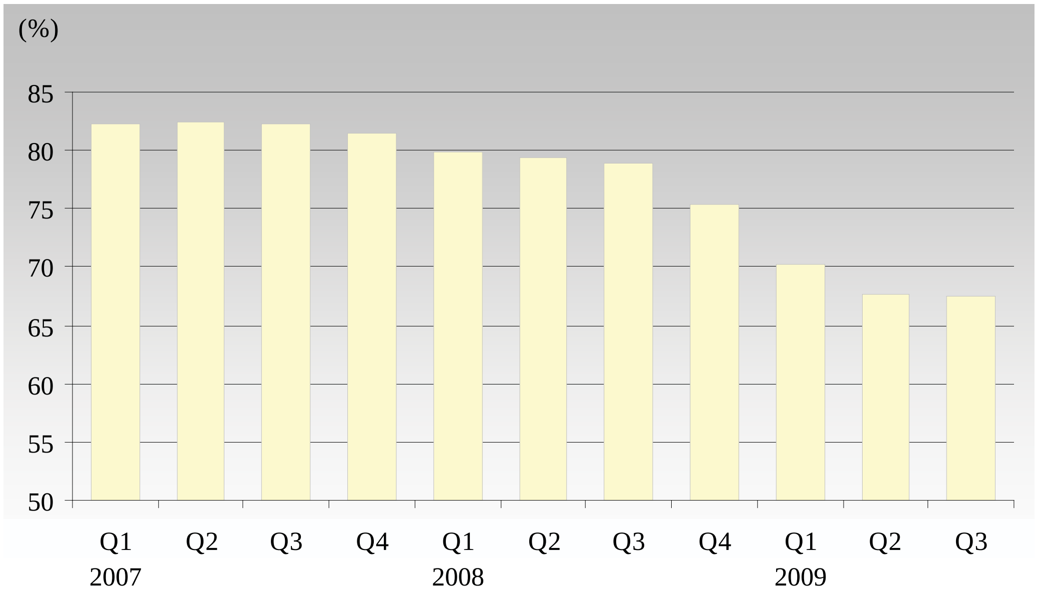


Source: Statistics Canada; the Canadian Chamber of Commerce. Forecasts are annual averages.

- **Business Output and Investment:** Many businesses are still grappling with an inventory overhang. The good news is the pace of inventory liquidation is slowing[7], and businesses will eventually begin restocking. This will help boost production and drive growth, particularly in the second half of 2010. Additionally, businesses are contending with a massive amount of unused capacity. Industrial capacity use, at 67.5 percent, is the lowest in over 20 years. Consequently, many businesses will be hesitant to expand and invest in structures (like factories, warehouses, and office buildings). This will remain an area of weakness, particularly in the near term, but as corporate profits bounce back, businesses will be more encouraged to take on such outlays. Lastly, the Bank of Canada's October *Business Outlook Survey* indicated, on balance, firms expect to invest about the same in machinery and equipment over the next 12 months as they did during the past 12 months.

7 The economy wide stock-to-sales ratio edged down in the third quarter, after trending up for five consecutive quarters. Businesses held inventories equivalent to 69 days of sales, down from 71 days in the second quarter.

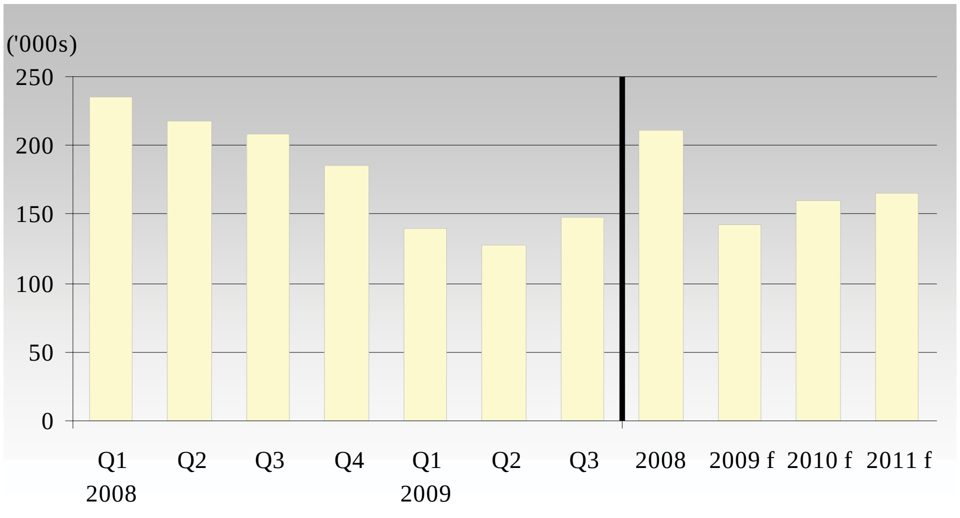
Total Industrial Capacity Utilization Rate



Source: Statistics Canada; the Canadian Chamber of Commerce.

- **Residential Investment:** While existing home sales continue to break new records, albeit from last year's very low base, homebuilders have taken a more cautious approach. As the Canadian economy slowly gains traction in the coming months, and unsold inventory of single- and semi-detached homes continues to fall, new home construction is expected to pick up and contribute significantly to real GDP growth. Overall, we forecast housing starts to average 160,000 units in 2010, up from and estimated 142,000 in 2009. It will take a number of years to attain the 200,000-plus level reached in 2008.

Housing Starts

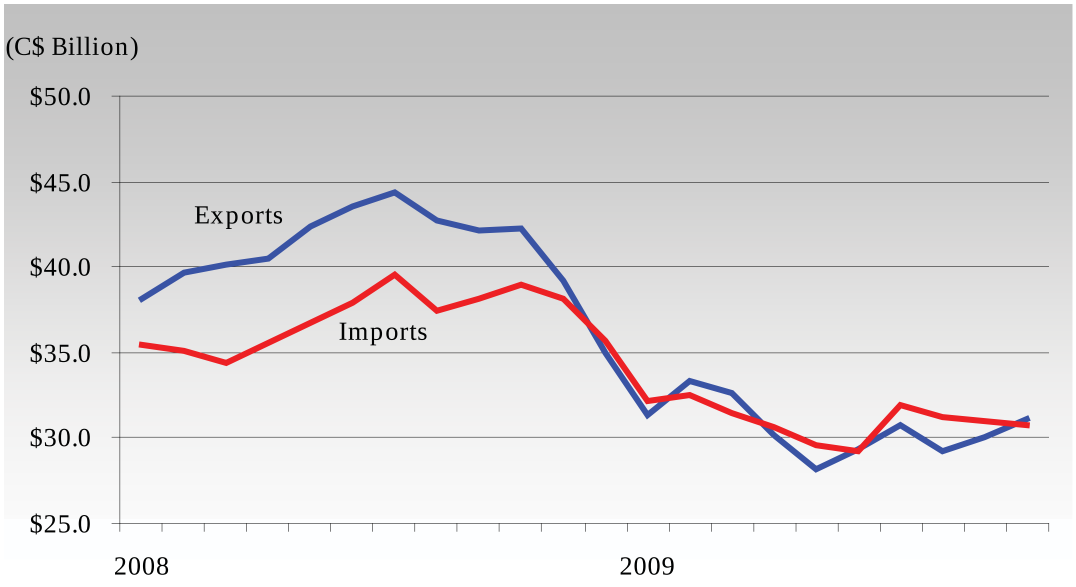


Source: Canada Mortgage and Housing Corporation; the Canadian Chamber of Commerce. f = forecast

- **Trade:** One of the major ingredients missing for a full-fledged recovery is robust demand south of the border. On net, about eight million private-sector jobs have been lost in the U.S. since December 2007, and the unemployment rate has risen from 4.4 percent in March 2007 to 10 percent. Many households are focusing on reducing debt and re-building their savings. These factors will constrain household spending and dampen Canadian exports for some time. Canada's share of the U.S. import market has already dropped significantly over the past decade. China is the largest U.S. supplier, followed by Canada, but the European Union as a whole had surpassed Canada as a supplier to the U.S.[8] At the same time, strong domestic demand and the high Canadian dollar will continue to stimulate imports. With imports rising more quickly than exports, net trade will contribute negatively to GDP growth in 2010.

- **Longstanding Competitive Issues:** A stronger Canadian dollar will also weigh on export growth and slow the recovery in 2010. The loonie looks set to hit parity and push slightly above parity in the first half of 2010, and hover in that range for the balance of the year. The Bank of Canada noted the persistent strength in the Canadian dollar is working to slow growth and, over time, to more than fully offset the favourable economic developments since July, 2009.[9]

Canadian International Merchandise Exports



Source: Statistics Canada; The Canadian Chamber of Commerce

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8 U.S. Census Bureau, U.S. Bureau of Economic Analysis. "U.S. International Trade in Goods and Services - October 2009." December 10, 2009. China has 20 percent of the U.S. import market, the European Union 17 percent, and Canada 14 percent.

9 Remarks by Mark Carney, Governor of the Bank of Canada. "The Evolution of the International Monetary System." Foreign Policy Association. New York, NY. November 19, 2009.

- Protectionism: Protectionist measures, in particular, the U.S. Buy American provisions tied to infrastructure investments have shut out Canadian producers of iron, steel, and manufactured goods from accessing billions of dollars of state- and municipal-level public procurement projects. According to the Council of State Governments, the U.S. has entered a three-month “peak” period in which about $300 billion in stimulus-funded infrastructure contracts will be awarded – contracts that Canadian companies may otherwise competed for and, in some cases, landed.

In summary, the Canadian economy will grow modestly in 2010 as a number of factors act to constrain growth. In 2011, economic momentum should pick up, with real GDP growth slated at 3.3 percent. The improvement in the outlook reflects better growth prospects in the U.S. and other trading partners (this will stimulate exports), firmer commodity prices (albeit partly offset by the high Canadian dollar), and the transition from policy-driven to private sector-driven growth.[10]

All provincial economies are projected to expand in 2010 led by Canada’s resource-intensive provinces in the West and East (British Columbia, Alberta, Saskatchewan and Newfoundland & Labrador). A rebound in global economic activity should spur a gradual rebound in commodities (prices and demand) and resource-sector investment pushing real GDP growth above the nation average in these provinces. British Columbia will also benefit from hosting the Olympic and Paralympic Winter Games. For manufacturing-intensive provinces (Ontario, Quebec, Manitoba, and New Brunswick), a strong Canadian dollar and feeble consumer spending in the U.S. will temper production and exports. Domestic demand will drive growth. Real GDP growth in these provinces is projected around or slightly below the national average. Recovery in Nova Scotia and Prince Edward Island will be on the soft side. The provinces’ tourism sector faces a challenging environment due to the persistently strong Canadian dollar. Export-oriented activities will continue to carve out a sluggish recovery. Construction of the Deep Panuke offshore natural gas project in Nova Scotia is winding down, and production is slated to start late 2010 / early 2011.

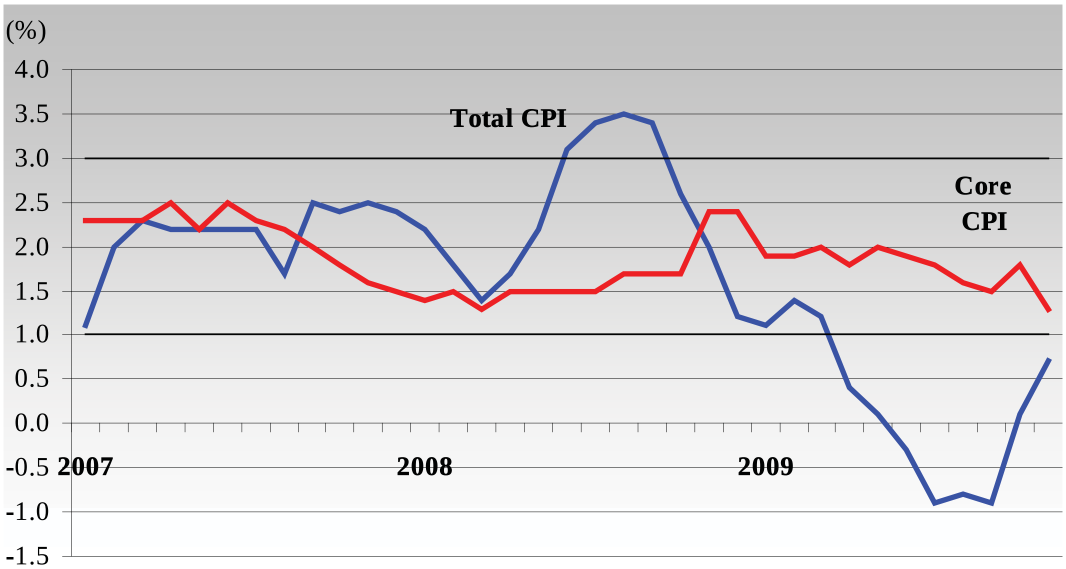
10 The temporary stimulus measures contained in *Canada’s Economic Action Plan* will end in line with the expected improvements in the economy – by the end of fiscal 2010–2011 (i.e. March 31, 2011). Companies that are benefiting from this temporary stimulus (either dependent on government procurement or incentives) should be prepared for its eventual withdrawal.

Inflation To Remain Low

Total inflation in Canada – measured as the year-over-year rate of change in the Consumer Price Index (CPI) – fell into negative territory in the third quarter of 2009 (-0.9 percent). Excluding the most volatile components of the Index[11], the core rate of inflation (1.7 percent in the third quarter) has remained well anchored and within the Bank of Canada's operational target (1 to 3 percent).

The persistently high dollar, substantial excess supply[12], high unemployment, and competitive pressures will continue to subdue inflation pressures. The All-items CPI is projected to average about 1.6 percent in 2010, and around 2.0 percent in 2011.

Consumer Price Index
(year-over-year percent change)



Source: Statistics Canada; the Canadian Chamber of Commerce

11 Fruit, vegetables, gasoline, fuel oil, natural gas, mortgage interest, intercity transportation, and tobacco products, as well as the effect of changes in indirect taxes on the remaining components.

12 Excess supply is the difference between actual output and potential output – the so-called 'output gap'. Actual output is represented by real GDP. Potential output is the level of goods and services that the economy can produce on a sustainable basis without adding to inflation pressures.

Bank Of Canada In No Hurry To Pull The Trigger

On December 8, the Bank of Canada held its overnight policy rate at 0.25 percent and repeated its pledge to hold at that level until the end of the second quarter of 2010, conditional on the outlook for inflation. We anticipate Canada's central bank to wait until the end of the third quarter of 2010 before increasing rates. The overnight policy rate is expected to finish 2010 at 1.0 percent, and year-end 2011 at 3.25 percent.

Risks

The two main risks to the outlook relate to the Canadian dollar and the global recovery. A stronger than expected appreciation in the Canadian dollar would act as a significant drag on growth. Additionally, a more protracted global recovery, especially south of the border, could further delay a rebound in exports, and impede the recovery in Canada.

An Agenda For Business Prosperity

In a rapidly changing global marketplace, businesses that adopt ambitious and outward-looking strategies will have the best hopes for success. For example, while the U.S. will remain Canada's most important trading partner, businesses also need to capitalize on new market opportunities in high-growth regions of the world, especially markets in Asia and the Pacific-Rim, but opportunities also beckon in Latin America, in countries like Brazil.

Moreover, to survive and grow in what promises to be highly competitive environment, businesses – in both the goods-producing and service sectors – must do more to find and employ new breakthrough technologies, constantly innovate, significantly increase investment in research and development, build internationally recognizable brands, cultivate a network of relationships and partnerships with businesses worldwide, upgrade the skills of their workforce, develop value-added products and services that are preferred by customers over other market alternatives, smartly manage supply chain relationships, relentlessly focus on improving operational efficiency, and build strong management capabilities aimed at achieving global leadership.

Not every business will be able to accomplish every single thing on this lengthy and challenging list, but all must understand the post-recession environment will be quite different than the one we knew before the downturn. The 'new normal' demands that even the smallest of businesses find ways to improve their competitiveness. Economic upheavals always create new opportunities, and the highest rewards will go to those that seize them.

Conclusion

The global economy is recovering from the most serious downturn since the Great Depression. Canada's economy has made important progress during the past year, and emerged from recession in the third quarter of 2009. Nonetheless, for many households, and the more than 1.5 million unemployed Canadians, it may not feel like a recovery. Experiencing the heaviest employment losses in the downturn were individuals working in the private sector (especially in manufacturing and construction), young people, low-paid workers, families with children, and core working-age immigrants who recently arrived in Canada.[13] The most important implication is that it is too early to begin to withdraw stimulus measures. "A premature withdrawal of the current monetary and fiscal policy stimulus could disrupt the recovery, raise job losses and intensify balance sheet pressures on the private sector."[14]

While the economy remains fragile, Canada enters this changed world with significant advantages. Our financial sector is solid, and overall financial conditions continue to improve and be more favourable than in most other countries. Furthermore, because our governments had reduced public debt and taxes over the past decade, we maintain greater fiscal flexibility than our competitors. These strengths have positioned Canada well to emerge from recession, and will serve us well going forward.

13 Statistics Canada. "Study: Canada's Employment Downturn." *The Daily*. November 12, 2009. Between October 2008 and October 2009, the number of employees in the private sector fell by 449,000, compared with a decline of 55,000 among public employees. In manufacturing, employment fell by 218,000 (-11.0 percent). Employment in construction declined by 73,000 (-5.8 percent). Employment among workers earning less than $10 an hour fell 24.8 percent, the largest decline. The majority (two-thirds) were youth. Single mothers with children were hit hard, with a 6.8 percent employment decline.

14 OECD. "Economic Outlook No. 86." November, 2009.

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