Economic Commentary

March 16, 2005

Where We Have Been? … Where Are We Heading?

In 2004 Canada's real GDP advanced by 2.8%, up from 2.0% growth in 2003, but slightly less than was expected in the Fall of 2004, although don't be surprised if this figure is revised upwards next year when more exact figures will be available. Exports for the year rebounded from 2003 despite the strength of the Canadian dollar while strong growth in final domestic demand was sustained at 3.8%. The Canadian dollar continued to strengthen against the US currency appreciating by 7.7% on top of the 12.1% advance in 2003. While exports increased 4.9%, imports increased even more, by 8.2% causing a significant decline in the country's trade balance.

Corporate surpluses surged as profits jumped 17.7% and companies took advantage of the stronger dollar and enhanced liquidity to increase spending on machinery and equipment by 9.4%. Industrial production increased 3.2% after a lackluster 0.7% performance in 2003 while manufacturers boosted production by 3.9% after a flat performance in 2003. The gains were spread across all of Canada's major sectors including the finance and insurance industries.

Despite a strong 4.1% growth in labour income, personal saving continued to plummet, as a 4.9% growth in spending outstripped income growth. The personal saving rate fell to 0.4% in 2004, which is the lowest level on record since the 1930s. With sustained growth in residential construction, personal sector net borrowing continued to climb. Household borrowing soared to a record $53 billion and the ratio of household debt to personal disposable income climbed to 105.8% by the fourth quarter. Household borrowing was led by continued demand for mortgage credit while consumer credit borrowing remained strong as well. With record low interest rates credit has been more affordable to consumers and despite the strong growth in household borrowing, debt servicing charges did not increase substantially in relation to income.

The combined surplus of all levels of government swelled to $17 billion, on a national accounts basis, with the federal surplus accounting for the bulk of this amount.

The fourth quarter results, however, were not as strong as those of the previous quarter. Quarterly growth downshifted dramatically to 1.7% at annualized rates in the 4th quarter from 2.9% in the 3rd quarter reducing the year-over-year change to 3.0% in Q4 from 3.4% in Q3. Exports slipped 0.9% in the 4th quarter in real terms. Corporate profits weakened in the second half of the year posting gains of only 1.5% in each of the last two quarters. The most worrisome of all, however, was a steep $19.2 billion jump in non-farm business inventories, which rose on top of a large accumulation in the third quarter.

As we look ahead into 2005, events are unfolding pretty much as forecast in the November Canadian Economic Outlook projection. That is, we expect growth in 2005 to be slower than 2004, a moderate rate of inflation and lower interest rate increases than were expected in the Fall of 2004. This scenario is what is being essentially played out so far this year. The growth rate is slowing, though at a faster rate than I had forecast in November. Instead of a 2.9% growth now I expect a 2.5%-2.6% rate of growth for the year as a whole. As far as the direction of interest rates is concerned, they will continue to rise, but at a more gradual pace than had been anticipated in my forecast. After raising the overnight rate by 50 basis points in late 2004, the Bank of Canada decided to stand pat in the first two rate-setting meetings of the year and is widely expected to stand pat until June at the earliest or early Fall at the latest.

Although the Federal Reserve in next week's (March 22nd) FOMC meeting is certain to raise the overnight rate to 2.75%, 25 basis points above the Canadian rate, and will continue to do so at a "measured pace" at least until the Fall, I expect that the structural twin deficit challenges facing the US currency to remain the dominant drivers in foreign exchange markets and therefore I would expect the Canadian dollar to appreciate further as the year unfolds.

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