Three-Year Macroeconomic Forecast for Canada: 2003 – 2005

- The global economic recovery has been uneven in 2003 but it is showing signs of improvement and is expected to accelerate in 2004 and through 2005, with the U.S. economy leading the way.

- Canadian growth has been dampened this year by the imposition of punitive tariffs on Canadian lumber by the U.S., by the breakout of severe acute respiratory syndrome (SARS), a single case of mad cow disease in Alberta which led to a complete shut-down in Canada's beef and live cattle exports to the world, the Ontario electricity blackout in August, the massive forest fires in British Columbia and the rapid appreciation of the Canadian dollar. All of these freak events coalesced to reduce Canada's growth from the 3.2% forecasted earlier on in the year to 1.9% forecasted now. The Canadian dollar experienced the most sudden advance in its 135-year history, rising so far this year by 20.7% against the U.S. greenback.

- The Canadian labour market has not been immune to these shocks. After a very strong performance in 2002, when the economy created 560,000 new jobs, employment growth slowed in 2003. Nonetheless, as of October 2003, the Canadian economy had created 164,000 jobs since the beginning of this year.

- Every fall, the federal Department of Finance surveys the country's top 20 private-sector economists and establishes a consensus forecast on Canada's macro economic indicators. These numbers are used by the Department to prepare it's economic forecasts and budget for the year. The values contained in this forecast are based on those of the Department of Finance announced by John Manley in his November 3rd, 2003 Economic and Fiscal Update.

- Private sector economists expect stronger U.S. growth and low Canadian interest rates to support a recovery in Canadian growth over the balance of this year and into 2004 and 2005. For 2003 they now expect real gross domestic product (GDP) growth of 1.9%. They forecast a 3.0% real growth in 2004 and 3.2% in 2005.

- Private sector economists believe that the extent and the speed of the appreciation of the Canadian dollar, as well as the uncertainty about future levels of the dollar, represent downside risks to their short-term growth forecast.

- Canada has been able to weather the recent downturn in the U.S. and global economy remarkably well. Unlike, the 1990-92 downturn, when Canada faired relatively worst than most countries, this time Canada's greatly improved fundamentals have made it possible for the country to go through this downturn relatively unscathed. Unlike the U.S. and most major economies, which experienced recession, Canada's economy did not experience one. In 2001, the lowest point of the global business cycle, Canada's economy managed to grow by 1.9% and then quickly bounced back to 3.3% in 2002.

- Some of the improved economic fundamentals include 1) the improved fiscal position of the government sector, deficits have given way to surpluses, with the country recording its sixth consecutive budget surplus in a row and headed for the seventh in 2003-04; 2) budget surpluses have allowed the repayment of government debt, with the debt-to-GDP ratio down from the second highest in the G-7 to the second lowest, and this in only a span of seven years; 3) Canada's external debt as a percent of GDP has fallen from 44% in the early 1990s to 16% in 2002, the lowest level in 50 years, thus increasing the country's independence and reducing its vulnerability to external shocks; 4) as a result of lower government borrowing, the national saving rate has jumped from 12.6% of GDP in 1992 to 21.5% in 2002, which means that that the supply of domestic savings now exceeds the demand; this has allowed interest rates to fall to record low levels and has allowed business fixed capital investment to rise to 20.5% of GDP; 5) Canada's international trade balance has shifted from massive current account deficits through the 1980s and early 1990s to surpluses well in excess of 2.0% of GDP, and this while the export share of the country's economy increased from 25% in the late 1980s to over 40% now; 6) the rate of productivity growth has almost doubled in recent years, jumping from 1.1% annual growth in the 1980s and early 1990s to 2.1% during the 1997-2002 period; 7) the improved fiscal picture is now saving increasing amounts of interest expense to service the public debt which have allowed the biggest tax reduction in Canadian history and is now making room for increased government spending on social programs; 8) the rate of inflation has been successfully kept around the target 2.0% rate for the last couple of years while 9) the country has maintained an impressive rate of job creation, creating 3,000,000 jobs since 1993, which has pushed the labour force participation rate up from 64.5% in 1996 to 67.6% this year, which has surpassed that of the U.S., the world leader since the middle of 2002.

- In 2004, Canada's growth in real output is expected to average 3.0% which is about average rate of growth in potential GDP. Despite the favourable fundamentals, which argue for an even higher growth rate, the 2004 forecast is more moderate because the appreciation in the value of the Canadian dollar will impact negatively on Canada's growth in exports to the U.S. as well as on the corporate profitability of its large export-oriented industries. Exports to the U.S. account for 82% of total exports, which account for 43% of GDP. In 2005, much of this drag on exports is expected to be absorbed and with continued growth in the U.S. and global economy, Canada's growth is expected to improve to 3.2%.

- The rate of consumer inflation is expected to remain below average, and to average 1.3% in 2004 and 1.5% in 2005. It is important to note that the Bank of Canada in its most recent monetary policy update expects consumer inflation to average even less than the country's private sector economists, namely 1.0%. The key reason for this favourable development is the recent appreciation in the value of the country's currency, which is reducing the cost of all imported goods and thus puts downward pressure on prices.

- As a consequence of abnormally low inflation, the central bank is expected to maintain short-term interest rates lower than it would have otherwise done in the face of economic expansion. Short-term interest rates as reflected by the 3-Month government treasury bill, are expected to average 2.9% in 2004, the same average level as 2003 and to edge higher in 2005 to an average level of 4.1%. Long-term interest rates, as reflected by the 10-year government bond yield are expected to edge higher only modestly, from an average of 4.8% in 2003 to 5.0% in 2004 and 5.4% in 2005. The prime rate, the key benchmark lending rate of Canada's chartered banks is thus expected to average 4.7% in 2004, that is about the same as in 2003 (4.69%) and move up to 5.5% in 2005, a modest increase of about three quarters of a percentage point. The "virtuous circle" of a strong currency, low inflation and low interest rates that marked the boom years of the late 1990s in the U.S.A. has now shifted to Canada with extremely positive implications for Canada for the next couple of years! It translates to higher investment, higher productivity growth, reduced tax burden and a sustained surge in Canadian living standards.

- The rate of unemployment is expected to fall to 7.4% in 2003 and 7.2% in 2005. Employment growth is not projected to be too high averaging 1.2% during the forecast horizon, because it is expected to be mitigated by a reduction of jobs in the export-oriented manufacturing sector, the victim of Canada's appreciated dollar, but also off-set by a strong surge in productivity growth.

- Growth in real personal disposable income (PDI) after slowing to 1.5% in 2003, is expected to jump to 2.9% in 2004 and 3.0% in 2005, the result of lower consumer inflation, lower taxes and higher economic growth.

- The value of the Canadian dollar, after rising by 20.6% so far in 2003, is expected to average 0.785 USD (USD = 1.274 CAD) in 2004 move even higher in 2005, averaging 0.815 USD in 2005 (USD = 1.227 CAD). In my view, this is a conservative estimate because the purchasing power parity (PPP) level of the Canadian dollar is between 80-82 cents US. Past history suggests that when a country undergoes the type of economic boom that Canada is about to embark, its currency usually overshoots its normal long-run value, just as the US currency should undershoot its long-run value as the country digests the post-bubble effects of its late 1990s boom.

Kenneth N. Matziorinis, Ph.D.
November 10, 2003
Canbek Economic Consultants Inc.