Swiss Re

Canadian Economic Outlook

April 14, 2003

The Canadian economy is still in good shape, but the US economy clouds the outlook.

All recent indicators of the Canadian economy suggest that the domestic economy is still healthy. Manufacturing shipments, wholesale sales, and retail sales all came in stronger than expected for January. The Ivey Purchasing Managers Index for March (at 65.9 vs. an expected 56.5) was strong in all categories. Also, the housing market continued its current winning streak. Housing starts, although lower in March, ended the first quarter 6.1% higher than the same quarter last year, and the new housing price index grew by a vigorous 0.6% in February. Clouding this rosy picture is the US economy. The outlook for the US economy has deteriorated over the past two months. The negative effect of US weakness can be seen in the 0.9% drop in exports to the US in February. However, with the war in Iraq in its final stages, oil prices falling, and some improvements in retail sales and confidence in March, the US economy is likely to continue growing.

Some indicators may weaken in the short run as the effects of SARS and the Iraq war are felt.

Some of the indicators may weaken in the short-run, but this should not be a source of major concern. Although retail sales were strong in January, the effect of people spending time watching the war rather than shopping should lead to temporary weakness in March and April. In addition, the labor force survey for March was mildly positive. The economy added 14,200 jobs, and unemployment fell to 7.3%. All of the growth was in full-time jobs, which grew at the expense of part-time jobs. Unfortunately, 32,600 of new jobs were created in the accommodation and food services sector, and the data was collected prior to March 15th, before the start of the war in Iraq and the severe acute respiratory syndrome (SARS) began to have an impact in Canada. With these two effects, job growth will probably weaken this month and next.

The Bank is likely to raise rates 50 basis points over the next two meetings.

The recent strong economic indicators, combined with the persistent high inflation, will probably cause the Bank of Canada to raise rates by 50 basis points over the next two meetings on April 15th and June 3rd. Nevertheless, there are many reasons for the Bank *not* to raise rates. The Canadian dollar is up almost 7% year-to-date. This will suppress inflation and diminish the relative attractiveness of Canadian labor, hurting future growth. Energy prices have fallen recently, reducing price pressures. There still remains a great deal of global uncertainty especially with regard to the US economy. However, Bank officials have downplayed many of these factors. Bank of Canada Senior Deputy Governor Paul Jenkins in a recent speech noted that final domestic demand "has remained robust" and "Canada's economy remains near full capacity." In addition, the war in Iraq is ending quickly, and growth in the second half of the year is expected to be vigorous. With good recent indicators, the Bank will move rates higher over the next two meetings.

Canadian Forecast Summary

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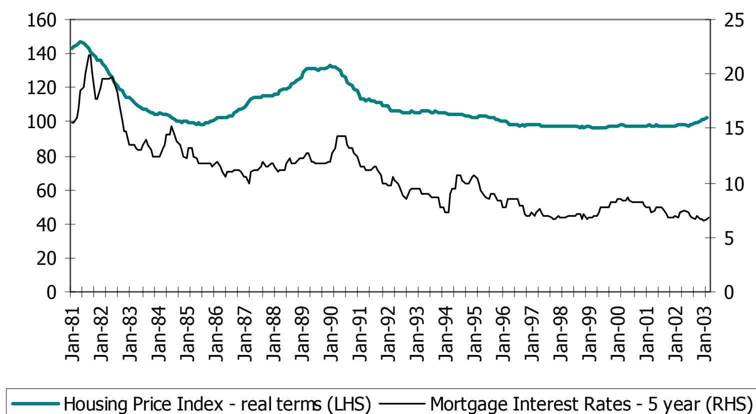
	History		Forecast →				Annual Data			
	02Q3	02Q4	03Q1	03Q2	03Q3	03Q4	2001	2002	2003	2004
Real GDP, % Change, SAAR	3.6	1.6	2.4	3.1	4.0	4.1	1.5	3.4	3.0	3.6
% Change, Year Ago	4.2	3.9	3.0	2.7	2.8	3.4				
CPI, SA, % Change, Year Ago	2.3	3.8	4.4	3.4	2.2	1.9	2.5	2.3	2.9	1.9
BoC Core CPI, % Change, Year Ago	2.4	2.8	3.0	2.4	2.1	2.2	2.1	2.4	2.4	2.1
			End of Period				End of Period			
Bank Target Rate, %	2.75	2.75	3.00	3.50	3.75	4.00	2.25	2.75	4.00	5.00
3-Month Treasury Bill Tender, %	2.8	2.6	3.1	3.5	3.9	4.1	2.0	2.6	4.1	5.0
10-Year Benchmark Bond Yield, %	4.9	4.8	5.1	5.4	5.6	5.8	5.4	4.8	5.8	6.0

Forecast prepared by Swiss Re Economic Research & Consulting, New York

Housing prices (real) and interest rates

Real housing prices, although higher recently, are still low by historical standards.



Source: Statistics Canada, Datastream, Swiss Re Economic Research & Consulting.

The Canadian dollar will get a boost from the Bank of Canada raising rates, especially if the Fed cuts.

With the Bank of Canada raising rates, and the US Federal Reserve possibly lowering rates, the Canadian dollar is expected to continue strengthening. Given the likelihood of three weak quarters in a row for the US economy—generally a signal for the Fed to cut, the Fed will probably cut rates before the end of the current quarter. The widening interest rate differential, will tend to boost the Canadian dollar. In addition, solid Canadian economic fundamentals, in the form of current account and federal fiscal surpluses will support the currency. However, volatile commodity prices could hurt the currency at times.

The housing sector has been particularly strong over the past year.

One area of possible concern is the housing market. The housing market has been very robust over the past year. Average housing starts for 2002 were up 26% over the previous year. Housing prices in February were up by 5.1% over the previous year. This market has been driven by strong employment growth, low interest rates, pent-up demand, and households seeking a safe haven from declining equity markets. The vigorous housing market has helped to buttress the economy over the past year in three ways: directly through residential investment and spending on household items such as furniture, through employment in the housing and construction sector, and indirectly through improving consumers' balance sheets. The current levels of prices and new construction have not been seen since the late 1980's, when the housing market contracted sharply after peaking in 1990. Such a collapse in the housing market would cause the economy to lose an important pillar of support.

Housing activity will continue to increase this year, although at a more modest pace.

However, there are several reasons why the housing market is unlikely to collapse over the next few years. First, housing prices in real terms, although high by recent standards, are much lower than in the late 1980's. Second, building permits are up 5% compared to a year ago, suggesting builders intend to continue building. Third, pent-up demand is high—according to a Royal Bank of Canada (RBC) survey in March, one quarter of Canadians are planning to buy a home in the next two years, with 11% planning on purchasing within six months. Finally, consumers are still able to afford new homes. RBC's housing affordability index, which measures the proportion of median pre-tax income used to service the costs of a typical first-time home, has risen to 32%, still far below the late 80's high of 49%. Also, the proportion of residential mortgages in arrears has been at the lowest in a decade, indicating that consumers are living within their means. Though the housing market will not decline sharply because of these factors, it is unlikely to grow robustly. Softening labor markets and higher mortgage rates will moderate growth in housing activity.

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