Swiss Re

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Canadian Economic Outlook

SARS, the BSE case, and a strong CAD have lowered growth this year.

Bad news seems to come in waves for the Canadian economy. Over the past month, a second outbreak of the Severe Acute Respiratory Syndrome (SARS), bans on Canadian exports of ruminant animal products due to the discovery of a single case of Bovine Spongiform Encephalopathy (BSE) on an Alberta farm, and a stronger than expected Canadian dollar have all combined to weaken the economy. The effect of SARS and BSE will likely be limited to the second and third quarters; however, there are signs of a broadening of economic weakness, particularly in the automotive sector. Despite the current gloominess, there are some signs that the second half and early 2004 will be strong. The US economy appears to have turned a corner, the index of Canadian leading indicators has averaged growth of 0.2% per month this year, and the Ivey Purchasing Managers Index (PMI) has stayed in growth territory (above 50). Nevertheless, the outlook over the next six months is clouded by the uncertainty over the extent and duration of the SARS problem and the BSE-related ban on meat exports.

Retail sales held up reasonably well given the SARS problem, but declining auto sales are lowering growth.

Retail sales in March and April both turned sharply negative. Headline retail sales fell 0.8% in March and another 0.9% in April. However, the decline was driven by volatile motor vehicle sales and declining gasoline station sales due to falling oil prices. Excluding these two factors, retail sales actually grew 0.4% and 0.1% in March and April. This growth is not bad, considering these months include the impact from the Iraq war and SARS.

The labor market has weakened. The strong Canadian dollar will hurt job growth going forward.

The labor market continued to weaken in May as the economy shed 13,000 jobs and unemployment jumped to 7.8%. This survey was made before the second SARS outbreak and before the BSE case was discovered, indicating that the weakness will continue for a few more months. Labor productivity declined in the first quarter of this year, the third consecutive decline, while productivity rose in the US. Also, the rise in the Canadian dollar (CAD) is making Canadian workers relatively more expensive. In the first quarter, a 7% surge in the CAD caused unit labor costs in US dollar terms to increase by 4.4% for Canadian workers, compared to 0.3% for US workers.

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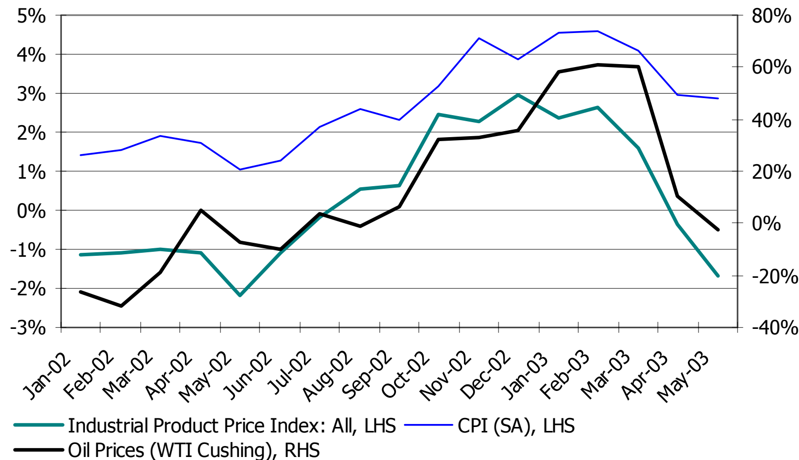
Canadian Forecast Summary

	History		Forecast→			Annual Data			
	02Q4	03Q1	03Q2	03Q3	03Q4	2001	2002	2003	2004
Real GDP, % Change, SAAR	1.6	2.4	1.0	3.3	4.3	1.9	3.3	2.4	3.4
% Change, Year Ago	3.5	2.6	1.9	2.1	2.8				
CPI, SA, % Change, Year Ago	3.8	4.4	3.0	2.3	1.8	2.5	2.3	2.9	1.8
BoC Core CPI, % Change, Year Ago	2.8	3.1	2.2	2.1	2.2	2.1	2.4	2.4	2.1
			End of Period			End of Period			
Bank Target Rate, %	2.75	3.00	3.25	3.25	3.50	2.25	2.75	3.50	5.00
3-Month Treasury Bill Tender, %	2.6	3.1	3.1	3.4	3.6	2.0	2.6	3.6	5.0
10-Year Benchmark Bond Yield, %	4.8	5.1	4.5	4.8	5.2	5.4	4.8	5.2	6.0

Oil prices and inflation, year-over-year percent change

Inflation has come down as oil prices have fallen.



The housing market has peaked, but lower interest rates should prop up activity through a few weak quarters.

The housing market seems to have plateaued after the labor market cooled. Housing starts declined in May by an annualized 4.7%, the third consecutive decline. Also, residential building permits, a leading indicator of housing activity, have weakened. There are no signs of a dramatic decline, however. Housing starts are still up 5.6% for the first five months of the year compared to the same period last year, and housing prices, up 4.5% over the previous year, continue to grow. With interest rates at their lowest level in three decades, housing activity should remain relatively strong.

The BSE-related export ban will lower output by about 0.2% this year.

The middle of this year is proving to be weaker than expected because of the second outbreak of SARS and the ban by many countries on imports of Canadian ruminant products. The bans generally cover all live ruminants (which includes cattle, sheep, and goats) and most ruminant products. In 2002, the value of ruminant-related exports totaled about CAD 4 billion, according to our calculations based on Statistics Canada data. This accounts for about 0.4% of GDP. Government aid and reduced internal prices should alleviate some of the impact for the overall economy. Assuming the US lifts its import ban by the end of September, we estimate a drop in output of about 0.2% for this year because of the BSE problem.

Inflation has fallen recently, and will likely remain low for the rest of the year.

Previous aggressive action by the Bank of Canada (BoC) and a rising dollar will keep inflation tame for the remainder of the year. Industrial product prices have fallen 2% in May and 1.6% in April, and raw material prices have fallen by an even more dramatic 2.5% in May and 6.8% in April. In May, the year-over-year growth in the consumer price index (CPI) fell to 2.9% for the total and 2.3% for the core. The stronger Canadian dollar and falling energy prices were responsible for this decline. The CPI might get a temporary boost over the next few months as Ontario electricity rebates unwind. These rebates caused a 10.1% drop in electricity prices after their implementation in April.

Despite recent economic difficulties, the Bank of Canada (BoC) will not cut rates.

Current economic weakness, a stronger Canadian dollar, and lower-than-anticipated inflation are providing the BoC with reasons to cut interest rates, after having raised them over the past eighteen months. However, it is unlikely that the Bank will cut rates. The Bank recognizes that the current weakness is largely due to the temporary effects of SARS and the BSE case. Also, the Bank has stated that it expects strong growth to resume late this year and early 2004. Currently, we expect the Bank to raise rates in the fourth quarter as the growth outlook clears, but they could delay raising rates into next year. As expectations of a cut diminish and a rise increase, 10-year interest rates should begin to climb, ending the year near 5%.

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