# Canadian Economic Outlook

March 17, 2003

Swiss Re

US weakness has negatively affected the outlook for the overall economy...

The Canadian economy spent most of 2002 seemingly immune to the problems of the rest of the global economy. This immunity may be coming to an end since external weakness caused real growth in the fourth quarter to drop to 1.6%, well below expectations. The outlook for the US economy has deteriorated significantly since the beginning of the year, and this will slow growth in Canada in 2003. The US economy will most likely be growing more robustly in the second half of the year, but high energy prices, falling consumer confidence, and the uncertainty stemming from the unresolved Middle East conflict have slowed growth in the first half of the year.

...but the domestic economy is still in good shape.

Though real Gross Domestic Product (GDP) growth slowed in the fourth quarter, the Canadian economy is still strong. The slowdown in growth was mostly attributable to an 8% decline in exports, due to a 17% fall in passenger vehicle shipments. Business investment also fell. Despite the investment decline, final domestic demand grew faster than in the third quarter at a healthy rate of 3.6%. The economy added 128,000 jobs and disposable personal income surged by an annualized 4.2%, fueling consumer spending of 4.4%. Low interest rates helped to boost residential fixed investment by 11.3%. The government sector also supported growth with a rise in net expenditures of 3.5%.

The recent indicators imply moderate growth in the first half of this year.

Recent indicators show the domestic economy will still be healthy in the first half of 2003. The labor market is strong as employment rose by 55,000 in February. This stength will sustain robust consumer spending and residential investment during the first half. The housing market continues to break records and exceed expectations. The value of building permits swelled 12.3% in January and housing starts rose sharply in February.

Employment growth will slow in the second half of 2003, moderating housing market activity and consumer spending growth.

Employment growth is expected to slow down in the second half of 2003, tempering consumer spending and residential investment. The Help-wanted index recorded another decline in February, the seventh consecutive monthly decline, and the Ivey Purchasing Managers Index (PMI) employment sub-index has been weak for the past six months. The relative cost advantage of Canadian labor declined in 2002 as unit labor costs in the US and Canada headed in opposite directions. In Canada, unit labor costs rose 0.3% in C$ terms, but US unit labor costs fell 1.7%. The 5.5% year-to-date rise in the C$ will worsen the relative attractiveness of Canadian labor. Rising interest rates should also contribute to a slow down in consumer spending and housing demand later this year.


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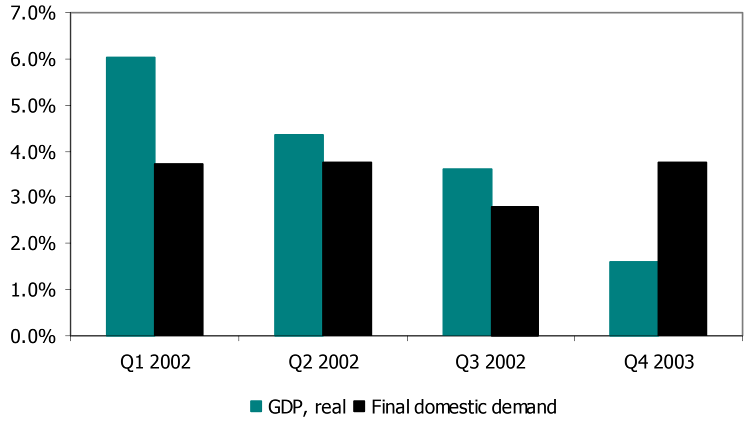
## Canadian Forecast Summary

| | History | | Forecast→ | | | | Annual Data | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 02Q3 | 02Q4 | 03Q1 | 03Q2 | 03Q3 | 03Q4 | 2001 | 2002 | 2003 | 2004 |
| Real GDP, % Change, SAAR | 3.6 | 1.6 | 2.5 | 3.5 | 4.0 | 4.1 | 1.5 | 3.4 | 3.1 | 3.7 |
| % Change, Year Ago | 4.2 | 3.9 | 3.0 | 2.8 | 2.9 | 3.5 | | | | |
| CPI, SA, % Change, Year | 2.3 | 3.8 | 3.9 | 3.4 | 2.2 | 1.9 | 2.5 | 2.3 | 2.8 | 1.9 |
| BoC Core CPI, % Change, Year | 2.4 | 2.8 | 2.9 | 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 | 3.25 | 3.50 | 3.75 | 2.25 | 2.75 | 3.75 | 5.00 |
| 3-Month Treasury Bill Tender, % | 2.8 | 2.7 | 3.0 | 3.4 | 3.6 | 3.8 | 2.0 | 2.7 | 3.8 | 4.8 |
| 10-Year Benchmark Bond Yield, | 4.9 | 4.9 | 4.9 | 5.4 | 5.6 | 5.7 | 5.4 | 4.9 | 5.7 | 5.8 |

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

### Growth comparison, GDP vs. domestic demand (SA, AR)

Although GDP growth has been slowing, domestic demand has remained stable.




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

The business sector, with an improved financial position, should increase investment later in the year.

Two sources of current weakness, business investment and exports, are expected to provide some strength in the second half of this year. In general, the business sector is healthy. The Ivey PMI came in higher than expected at 59.2, an increase of 9% over the previous year. After-tax corporate profits surged by 10.2% in 2002, and operating profits rose by 5.8%. Operating profit growth was especially strong, at 9.6%, in the non-financial sector. Also, the use of debt by non-financial private corporations fell sharply in 2002. Rising profits combined with decreasing debt burdens will allow for greater business sector investment. Businesses have been on hold in the face of global uncertainty, despite high capacity utilization rates and relatively tight labor markets. As global uncertainty abates, business investment will increase. However, because inventories have been rising over the past year, this investment will be delayed until the second half of 2003.

The external sector will improve with the US economy, but non-US trade will help in the mean time.

The external situation has worsened along with the US economy. The outlook for the US economy in the first half has been lowered. In addition, the competitiveness of Canadian exports has been hurt by the rise in the Canadian dollar against the US dollar. Trade with other countries will help mitigate some of the loss of US trade since the loonie is still weak versus other currencies. The trade numbers for January show this effect as the US trade surplus fell C$360 mn, but the trade deficit with the rest of the world fell by C$1.2 bn. In the second half of the year, the US economy should improve significantly, supporting improved export growth.

The Bank continues to be in a rate increasing posture.

On March 4 in a surprise move, the Bank of Canada (BoC) increased its target interest rate by 25 bp. This decision was a difficult one because real GDP growth appears to be slowing. However, inflation is accelerating, with the BoC core rate of inflation in January at 3.3% year-on-year, slightly above the Bank's target ceiling of 3%. The Bank cited strong domestic demand and improving financial market conditions as additional reasons for the hike. In a recent interview, Bank of Canada governor David Dodge downplayed the impact of the rising currency in suppressing inflation. Relatively weak growth in the first half of the year will probably keep the Bank on hold until June. Long term interest rates will drift up in the second half of the year, as the economy gains strength and the Bank continues to raise its policy rate. The 10-year Benchmark bond yield will rise to 5.5% to 6% by year-end.