THE CANADIAN CHAMBER OF COMMERCE
LA CHAMBRE DE COMMERCE DU CANADA

Policy Brief

Economic Policy Series – December 2012

2013-14 Economic Outlook

Still Stuck in the Slow Lane

Introduction

The global recovery has suffered new setbacks. "A key reason is that policies in the major advanced economies have not rebuilt confidence in medium-term prospects."[1] Europe is in recession, other advanced economies are growing only modestly, and China and other large emerging-market economies have slowed from their blistering pace of growth of recent years.

Canada's economy continues to recover from the Great Recession, but the recent pace of growth has been slower than many had hoped.

For the most part, economic growth in Canada has been sideswiped by the fallout of reduced global demand for our exports. At the same time, high uncertainty is weighing heavily on the spending decisions of Canadian businesses.

Global economic prospects are expected to steadily improve in 2013, provided some compromise is reached in Washington to avoid the so-called fiscal cliff—the mix of tax increases and spending cuts scheduled to take effect at the beginning of 2013—and the eurozone continues to make progress toward resolving the sovereign debt crisis.

1 International Monetary Fund. "World Economic Outlook." October 2012.

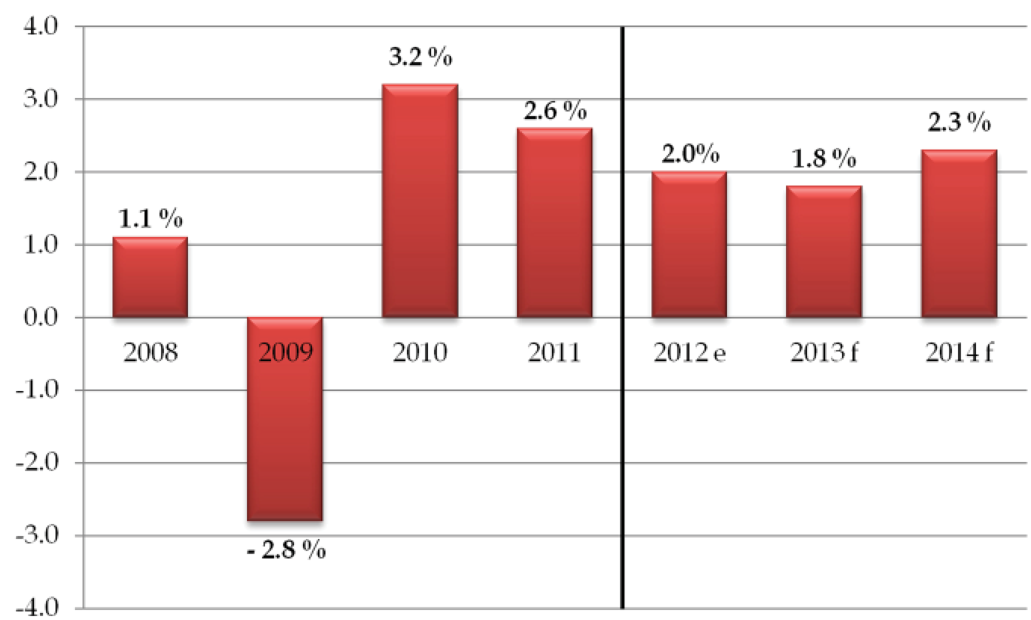
The Canadian Chamber is committed to fostering a strong, competitive and profitable economic environment that benefits all Canadians. This paper is one of a series of independent research reports covering key public policy issues facing Canada today.

We hope this analysis will raise public understanding and help decision-makers make informed choices. The papers are not designed to recommend specific policy solutions, but to stimulate public discussion and debate about the nation's challenges.

Canadian exports should pick up gradually as foreign demand improves, but they will be restrained by ongoing competitiveness challenges. On the domestic front, record high household debt will dampen consumer spending. Additionally, housing activity, which has been an important pillar of economic strength, is expected to cool from historically high levels. Finally, governments will stay focused on reining in spending to balance their books, while businesses are generally more circumspect about near-term investment decisions. Under these conditions, Canada's economy will be hard-pressed to generate consistently stronger growth momentum.

We predict Canada's economy will grow by 1.8 per cent in 2013—slightly less than the 2.0 per cent growth rate projected for 2012 and well below 2011's pace of 2.6 per cent. Growth is expected to accelerate to around 2.3 per cent in 2014, reflecting improving global and domestic economic conditions.

Real Gross Domestic Product
(annual % change)



Source: Statistics Canada; The Canadian Chamber of Commerce. e = estimate, f = forecast

Canada's Economy Is Expected to Post Moderate Growth in 2013-14

Consumers are tapped out

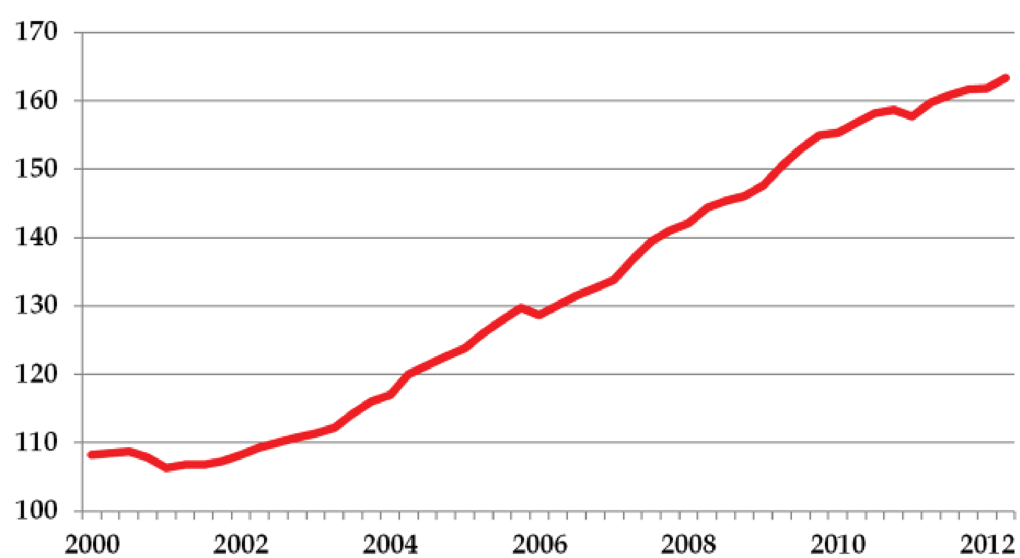
After a decade of relatively strong spending and borrowing, Canadian consumers have geared down in the face of heavy debt loads. Canadian households owe an average of $1.63 for every dollar of disposable income, more than either their Americans or British counterparts.

The Governor of Bank of Canada and the Minister of Finance have warned consumers to be more cautious, and they are listening. Consumer credit growth has fallen to a two-decade low and mortgage borrowing has slowed.

As a result, consumer spending is on track to rise 2.0 per cent in 2012, marking the slowest annual pace of growth since 1993. With consumer spending accounting for 56 per cent of the economy, it is no wonder underlying momentum has been soft.

With relatively slow job growth over the coming months[2] and record high household indebtedness, Canadians are expected to remain cautious shoppers going forward.

Ratio of Household Debt to Personal Disposable Income (%)



Source: Statistics Canada; The Canadian Chamber of Commerce.

2 We expect employment to increase by an average of about 15,000 jobs per month in 2013. For 2013 as a whole, the unemployment rate is expected to average 7.1 per cent compared to 7.3 per cent in 2012.

Housing activity is poised to moderate

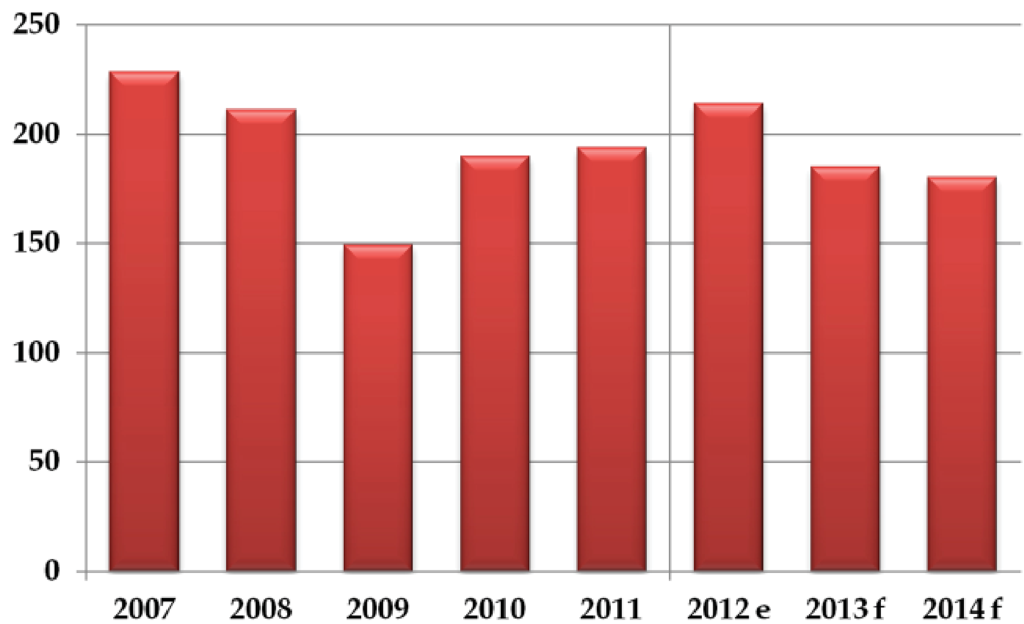
Tighter mortgage insurance rules implemented in July 2012 have taken some of the steam out of Canada's housing market. In the past six months, sales of existing homes have declined, and the growth in house prices has slowed. The soft landing everyone was hoping for appears to be underway. However, conditions vary considerably from city to city. For example, home sales have tumbled in Greater Vancouver, and activity has softened in Greater Toronto while Calgary and, to a lesser extent, Edmonton are witnessing robust sales activity.

Housing activity should cool in 2013 in response to elevated household debt and stricter mortgage rules. With housing demand retreating, the pace of new homebuilding is also expected to recede.

On an annual basis, we forecast housing starts to average approximately 214,000 units in 2012, 185,000 units in 2013 and 180,000 units in 2014. The 2013 and 2014 levels are more consistent with the rate of household formation.

The moderation in homebuilding activity is likely to cut into consumer spending, retail sales and employment.

Housing Starts ('000)
(seasonally adjusted at annual rates)



Source: Canada Mortgage and Housing Corporation; The Canadian Chamber of Commerce.
e = estimate, f = forecast

Government spending restraint will weigh on economic performance

Federal and provincial governments are reining in spending to balance their books. The federal government projects it will return to budgetary balance by fiscal 2016-17, and the majority of the provinces are targeting balanced books for fiscal 2013-14 or fiscal 2014-15. The exception is Ontario; it is aiming to achieve balance by fiscal 2017-18. Saskatchewan is already in the black.

With the focus on fiscal restraint, government spending will make little contribution to overall real GDP growth in 2013 and 2014.

Business investment in fixed assets will continue to support growth

Business investment in fixed assets has been a major contributor to the economic recovery. Strong corporate balance sheets have provided businesses the financial capacity to invest. Investment in non-residential structures (real estate) has been particularly robust in recent years. Additionally, low borrowing costs and the lofty Canadian dollar have made it cheaper to purchase machinery and equipment, much of it imported from the U.S.

The balance of opinion on investment decisions remains positive; however, in an environment of slow global economic growth and uncertainty about demand, businesses have tempered their capital spending plans.

The Bank of Canada's autumn *Business Outlook Survey*[3] indicated that 37 per cent of firms expect to invest more in machinery and equipment over the next 12 months than they did during the past 12 months. This is down from 43 per cent in the summer survey. Thirty-four per cent of firms expect to invest about the same.

Additionally, softer export volumes and uncertainty surrounding much higher commodity prices have led some companies in the resource sector to scale back longer-term expansion plans.

Once the global economic landscape improves—likely by mid-2013—and uncertainty subsides, businesses will have more confidence to invest in plant, machinery and equipment.

Low vacancy rates should continue to support commercial construction (in office buildings and shopping centres) going forward.

3 October 15, 2012.

Canada needs to diversify its export markets

With Canada's domestic engines of growth sputtering, our export performance has to improve to achieve higher economic growth.

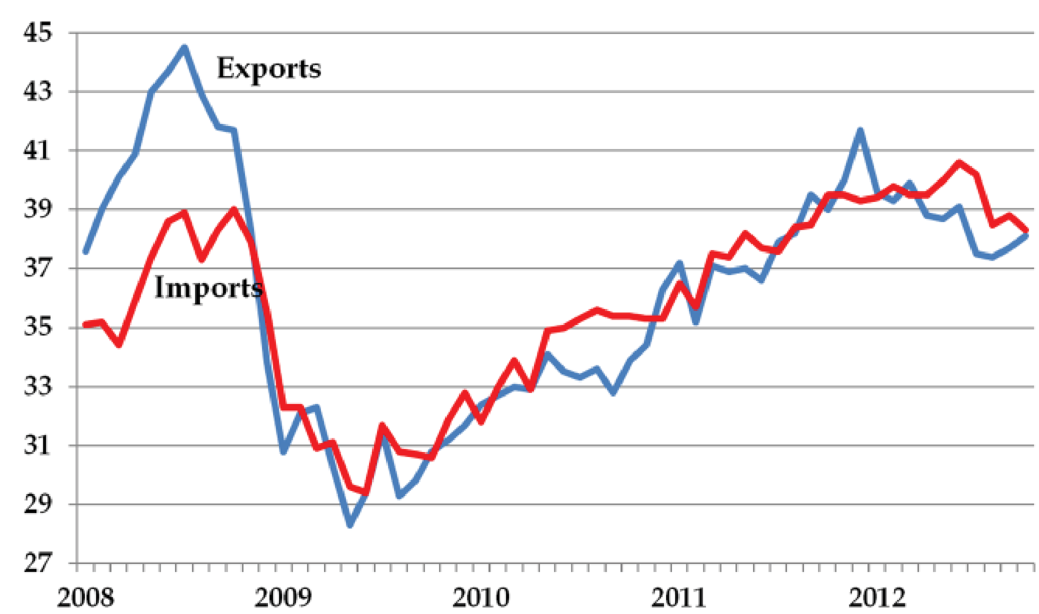
Canadian exports have yet to recover all the ground lost during the recession, while imports surpassed their pre-recession peak last year.

Much of the sluggish recovery in exports reflects Canada's reliance on the softer U.S. market rather than faster-growing emerging markets. Canadian exports are also constrained by ongoing competitiveness challenges. The dramatic appreciation in the Canadian dollar since 2002 and slow productivity growth over the past decade have sharply increased unit labour costs, eroding the competitiveness of Canadian-made products. Since 2000, Canadian exporters have lost a quarter of their share of the U.S. market.

Canadian exports are expected to remain lacklustre through the first half of 2013, but should pick up gradually in the second half of the year as the U.S. economy gains momentum and the global outlook becomes more certain. On the other side of the ledger, imports are expected to grow modestly reflecting the anticipated moderation in Canadian household spending.

While the U.S. will remain a very important market for Canadian exporters, economic growth going forward will depend on whether we can capture more market share in the faster-growing regions of Asia Pacific and Latin America.

Canadian International Merchandise Trade (C$ billion, seasonally adjusted)



Source: Statistics Canada; The Canadian Chamber of Commerce.

Inflation Expectations Are Well Anchored

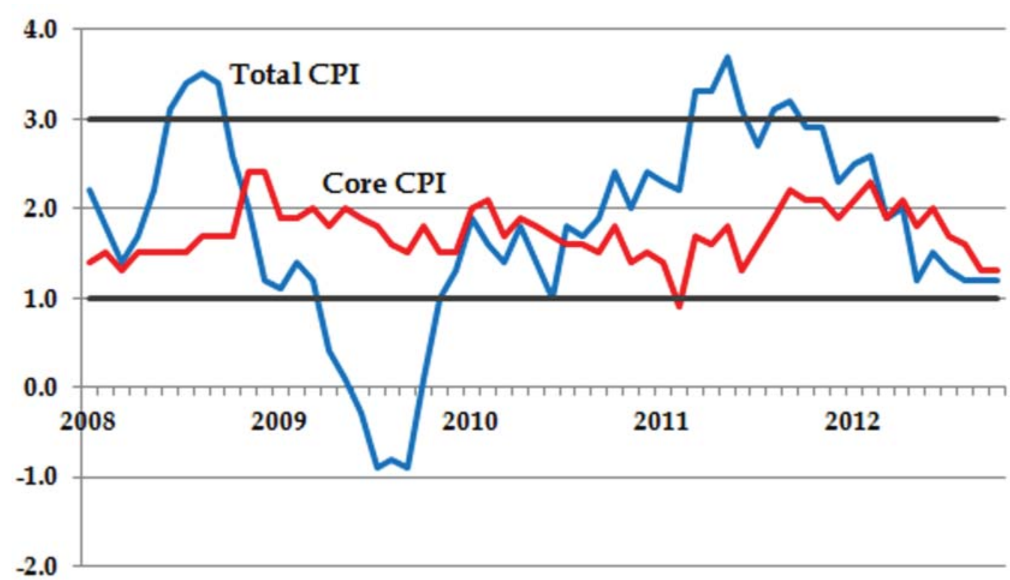
Inflation continues to be a non-issue for the Canadian economy. Headline inflation, as measured by the All-items Consumer Price Index (CPI), has generally been falling since May 2011, and is at its lowest point since June 2010. The Bank of Canada's closely watched core measure of inflation (which excludes the eight most volatile components of the CPI, like food and energy, as well as the effect of changes in indirect taxes) has also been on a downward trend since the beginning of 2012.

A strong Canadian dollar, cross-border shopping and the influx of more American retailers will keep a lid on consumer prices going forward.

The Bank of Canada expects both core inflation and total CPI inflation to increase gradually towards the Bank's 2.0 per cent target over the course of the next 12 months.

Overall, 95 per cent of businesses expect inflation to remain within the Bank of Canada's 1.0 per cent to 3.0 per cent inflation-control range over the next two years.

Consumer Price Index
(year-over-year percent change)



Source: Statistics Canada; The Canadian Chamber of Commerce.

The Bank of Canada Is Expected to Stay on the Sidelines Until Early 2014

The Bank of Canada's benchmark overnight rate remains at 1.00 per cent where it has been since September 2010.

The December 4, 2012 policy announcement maintained the Bank's bias to eventually raise rates, stating "over time, some modest withdrawal of monetary policy stimulus will likely be required… The timing and degree of any such withdrawal will be weighed carefully against global and domestic developments, including the evolution of imbalances in the household sector."

Amid the tepid economic backdrop and the litany of downside global economic risks on the radar, the Bank of Canada is expected to remain on hold until early 2014.

The Canadian Dollar Will Remain Close to Parity

The Canadian dollar remains strong despite modest economic growth and our sizeable current account deficit. Clearly, Canada is viewed as a relative safe haven in a world of uncertainty, and as *The Globe and Mail* recently noted, the loonie is poised to join an elite group of global reserve currencies.[4]

Foreigners, including foreign central banks that are diversifying their foreign exchange reserves, have been investing heavily in Canadian fixed-income instruments.

Foreigners now hold a quarter of Government of Canada bonds, nearly double the amount held in 2008.

Our sound banking system, triple-A credit rating, comparatively better fiscal position, credible monetary policy and firm underlying economic fundamentals are all factors that will continue to contribute to Canada's safe haven status and drive foreign demand for the Canadian dollar.

The Canadian dollar's strength will also reflect U.S. dollar's weakness. The U.S. Federal Reserve will continue buying assets to lower the cost of borrowing to stimulate growth and to add liquidity to financial markets. As long as the Fed is engaged in asset purchases, the U.S. dollar will remain under pressure.

Dampening these positive drivers for the Canadian dollar will likely be recurring spikes in risk aversion (which tend to favour the U.S. dollar). Most notably, a flare up of the eurozone debt crisis or heightened geopolitical tensions would weigh on the Canadian dollar. Additionally, the trend of slower growth in Canada relative to the U.S. will tend to favour the U.S. dollar.

On balance, the positives appear to outweigh the negatives suggesting the Canadian dollar will generally trade at slightly above parity (within a couple-cent range) over the forecast horizon.

4 McKenna, Barrie. "Loonie poised to join elite group of global reserve currencies." *The Globe and Mail*. November 19, 2012.

In Summary

This report provides the Canadian Chamber of Commerce's baseline forecasts based on information available to mid-December 2012.

Needless to say, these are very uncertain times for the global economy, and the risks to our outlook and forecasts are significant.

With more than 70 per cent of Canada's trade eggs in the U.S. basket, we can only hope the U.S. gets its financial house in order. To achieve more robust growth in Canada, we need exports to pick up, and for that to happen, we need American consumers to spend more and businesses to invest more. But, they will only do that if they feel more confident about the economy and the direction of fiscal policy.

Europe remains another danger spot. European politicians have so far managed to kick the can down the road, but they have not resolved the issues that threaten to break up the eurozone. While our trade with Europe is just a fraction of the business we do with the U.S. (less than 10 per cent of our exports go to western European countries), Europe's troubles are dragging down global growth, including China's—an increasingly important customer for Canadian commodities.

We also need to be concerned about trouble spots like the Middle East. Here again, Canada's ability to influence events is limited, yet we will most certainly feel the effects. An escalation of geopolitical tensions in the Middle East would send crude oil prices sharply higher, crimping global growth.

On the domestic front, the major risk relates to elevated levels of household indebtedness. Canadian households—especially low-income Canadians—are more vulnerable to rising interest rates, job loss and asset price declines than in the past.

Not all of the risks to the outlook are on the downside. The recovery in the U.S. may be stronger than anticipated, lifting demand for Canadian exports. The tone of recent U.S. data has been encouraging—the housing recovery is gaining traction, the job market has improved and consumer credit growth is rising. "Cooperation and creativity to deliver fiscal clarity—in particular, a plan for resolving the nation's longer-term budgetary issues without harming the recovery—could help make the new year a very good one for the American economy."[5]

5 Bernanke, Ben S. "The Economic Recovery and Economic Policy." Speech at the New York Economic Club. New York, New York. November 20, 2012.

Additionally, government stimulus efforts in China, including a push for more infrastructure investment, could induce a stronger than expected rebound in activity in that country which could increase import demand and bolster commodity prices. Canada, being a large producer and exporter of energy, base metals and lumber, would benefit.

"It's true that Canada weathered the recession better than the other G7 countries, and we're still in relatively good shape; but in this increasingly global environment, our economy can't improve until other nations—namely Europe, China and especially the U.S.—see their own financial fortunes rebound."[6]

Let's hope 2013 brings a prosperous year to us all.

2013 Provincial/Territorial Outlook: Economic Performance Will Vary Across the Country

All provincial economies are projected to expand in 2013 with Canada's resource-rich provinces leading the pack.

Alberta is forecast to enjoy the highest growth rate in the country for the third consecutive year, followed closely by Saskatchewan. Both provinces are projected to achieve real GDP growth of close to 3.0 per cent.

A very tight labour market in **Alberta** will continue to drive wages higher and propel consumer spending. With the labour market in high gear and net interprovincial and international migration remaining strong, housing starts and home sales activity are anticipated to stay strong. The energy sector will remain the key driver of growth.

In **Saskatchewan**, strong job growth and wage gains and a very robust increase in population—helped by higher net international migration—will spur retail sales and home construction. The outlook for mineral exploration and development is positive. Additionally, the provincial government has opened Crown land for oil sands exploration—the first such sale since 2007. Lastly, the province's superior fiscal position gives it a unique advantage relative to other provinces.

Economic growth in Manitoba and British Columbia is also expected to exceed the national average, with real GDP expanding by around 2.3 per cent in both provinces. **Manitoba** has a highly diversified economy with a major presence in manufacturing, transportation, wholesale trade, agriculture, mining, finance and insurance. Such diversification makes Manitoba's economy one of the most stable in Canada as a cyclical downturn in one industry can typically be offset by growth in another. With two new mines under construction in the province and several projects moving towards development, Manitoba's mining sector is poised for growth. A rebound in global demand in 2013 will deliver a shot in the arm to the industrial goods sector, which accounts for close to 30 per cent of

6 Borzykowski, Bryan. "Global outlook 2013: Finding success in a risky market." *Canadian Business*. December 3, 2012.

the province's exports. The equipment and machinery and transportation sectors also stand to gain.

In **British Columbia**, a housing correction is underway which may cut into consumer spending, retail sales and employment in 2013. On the other hand, an improvement in B.C.'s key export markets should provide support. Specifically, a firming in China's growth rate, partly as a result of stimulus measures, will provide a boost to B.C.'s forestry sector as China takes in more than 20 per cent of the province's wood product exports. Similarly, B.C.'s lumber industry will benefit from the improving trend in U.S. homebuilding activity.

Central Canada (Ontario and Quebec) faces a more challenging environment. Real GDP growth of below the national average is projected for these provinces. In **Ontario**, expectations are for a cooling in homebuilding activity. Fiscal restraint (at the provincial and federal levels) will also weigh on growth in the province. While Ontario's export-oriented manufacturing sector will continue to be squeezed by the strong Canadian dollar, its performance should continue to improve as the U.S. economy gradually picks up steam. **Quebec's** manufacturing sector will also benefit from the anticipated rebound in activity in the U.S., but a weak job market and tax hikes will squeeze consumer spending. Provincial infrastructure spending has been scaled back to restrain growth in government expenditures, and several mining projects have been put on hold until the provincial government finalizes a royalties regime and further clarifies exploration rules.

Economic growth in **New Brunswick** and **Prince Edward Island** is expected to come in below the national average. Weak public sector capital spending will weigh on construction activity in both provinces, while income and consumer spending will be restrained by weak job growth. Potash Corporation's Sussex, New Brunswick mine will be shut down until late February due to a slump in demand for the commodity. On a positive note, the Point Lepreau nuclear generating station in New Brunswick has returned to commercial operation after a multi-year refurbishment which puts the province back in a position to export electricity.

In **Nova Scotia**, the Deep Panuke natural gas project has been delayed because the gas field's offshore platform will not be ready until sometime during the first half of 2013, and production from the Sable Offshore Energy Project continues to dwindle. The province should get a boost in late 2013 from the $25 billion federal shipbuilding contract.

In **Newfoundland and Labrador**, a vibrant resource-based economy will lift economic growth above the national average. Sustained capital investment in the province's mining and offshore oil sectors (for example, the Hebron megaproject) will generate further improvements in employment and support provincial taxation revenues. In late November 2012, the federal government announced a federal loan guarantee for the Muskrat Falls hydroelectric project on Labrador's Lower Churchill River, clearing the final major hurdle to launching the project. One note of caution: with natural resource production accounting for over 40 per cent of provincial GDP, the province's economy is susceptible to commodity price volatility and project and operational risks.

Mining activity will continue to drive economic growth in **Canada's North**. Recently released figures from Natural Resources Canada show that an estimated $535.7 million was spent on mineral exploration in Nunavut in 2012; $331.7 million was spent in the Yukon Territory and $93.8 million was spent in the Northwest Territories. Mining projects in the North continue to advance through the approval process. In early December 2012, the federal government approved construction of the massive Mary River iron ore project in **Nunavut** (north Baffin Island), a move that could jump-start development of the Canadian Arctic. The mine would also require the construction of a road, a 150-km railway and a deep-water port. Construction on the project could begin as early as July 2013 at a cost of $4 billion. During the construction period, the mine and related developments would require 1,700 to 2,700 workers, and then 950 people to run the operations. In the **Northwest Territories**, work is underway to extend the life of the Diavik Diamond Mine. Lastly, a proposal has been submitted for the Izok Corridor project in **Nunavut** which is expected to produce 180,000 tonnes of zinc concentrate and 50,000 tonnes of copper concentrate per year once in production. During the two-year construction period, 1,140 people would find work, and then 710 would have jobs at its underground and open pit mines.

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