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CANADA

2002: STRONG PERFORMANCE

The Canadian economy made a strong showing in 2002. Full year growth came in at just under 3.3 per cent—a relatively good performance by international standards. Despite the robust numbers, growth slowed through the year. After starting 2002 with two very impressive quarters (annualised real GDP in first-quarter 2002 was 5.8 per cent, and 3.8 per cent in the second quarter) the second half of 2002 was less impressive (2.7 per cent in the third quarter, 1.6 per cent in the fourth quarter).

One important story in 2002 was the growth in employment. The Canadian economy created over 500,000 new jobs in the year up to fourth-quarter 2002, representing growth of over 3 per cent. The gains were broadly based, both sectorally and geographically, and more than half of the new jobs were full-time positions. Solid employment growth combined with favourable monetary conditions to generate strong demand for personal consumption, especially of durables, and very robust residential investment. On the other hand, Canadian firms also engaged in increasingly significant inventory building as the economy slowed through the year, culminating in fourth-quarter numbers that were more than double the 10-year average. If this above-average stockbuilding had not occurred, the Canadian economy would have expanded by less than 1 per cent during the second half of 2002.

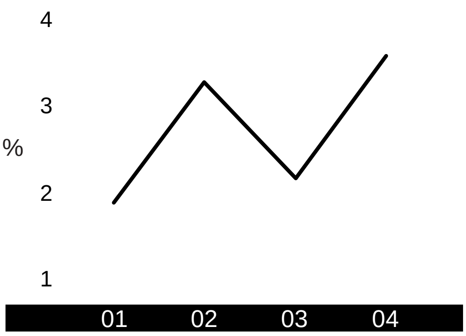
On an annual basis, net exports contributed virtually nothing to growth in 2002 owing to a dismal fourth quarter in which merchandise exports declined by almost 9 per cent (annual basis). The decline, which helps to explain the growth in inventories, is largely attributable to slower auto exports, though drought-related shortages also contributed to reduced agricultural exports, especially of wheat. In balance of payments terms, Canada recorded a solid current account surplus in 2002, though it was slightly smaller than in either of the two previous years.

Monetary policy. The Bank of Canada reduced the Bank Rate by 25 basis points on 15 January 2002. This was the last in a long string of cuts that had begun in January 2001, and took the Bank Rate from 6 per cent to 2.25 per cent. Soon, the Bank decided tightening was in order. It increased rates three times by midyear, taking the Bank Rate back to 3 per cent. The rate remained at that level until early March 2003, when another 25 basis point increase was made, followed by an additional 25 basis points in April.

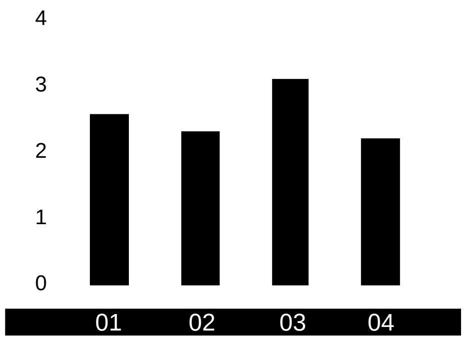
On a year-on-year basis, various measures of CPI inflation in 2002 were around the Bank's target rate of 2 per cent. Even at 2 per cent, inflation was higher in 2002 than had been expected due to some 'one-off' events like tax and insurance premium increases. While these high numbers can be rationalised, the Bank is concerned that people will nonetheless begin to expect higher prices.

We build another 125 basis points into our forecast. These moves, combined with the contractionary impact of the recent appreciation of the Canadian dollar (which we expect will be

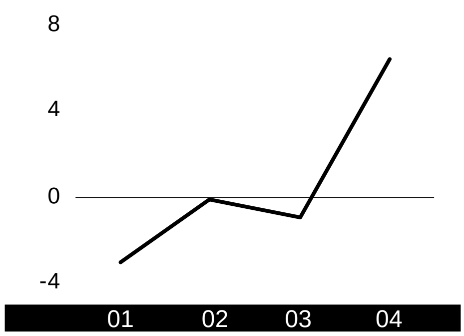
GDP growth



CPI inflation



Export growth



sustained), will leave the Bank Rate at 4.75 per cent and should be sufficient to ensure that, by the end of 2004, inflation numbers are hitting the Bank of Canada's target.

Fiscal policy. Finance Minister John Manley unveiled his first budget in February 2003 with C$15 billion in net spending increases, allocated in varying degrees to fiscal years 2002–04. Important components include C$8 billion for health care, and another C$ 5 billion for defence, international assistance, sustainable development (including climate change initiatives), and research and innovation. There were also some modest revenue initiatives, including the phasing out of a corporate capital tax, an expansion of Canada's tax-advantaged savings program, greater tax benefits for those with children, and a reduction in employment insurance premia.

While the emphasis has shifted from tax reduction to spending, the magnitude of the new initiatives (relative to GDP) is modest, and so too will be their impact on the outlook. Manley's budget adopted the tradition of building in a 'prudence' factor to cover shortfalls that may result from inaccurate forecast assumptions and a contingency reserve that can be used to deal with unforeseen events. These funds will, if not required, be allocated to debt reduction.

Other inputs. In addition to fiscal and monetary policies, our forecast is conditional on a number of external variables. External demand for Canadian goods is a crucial input to the forecast. We expect that external activity levels—particularly those in the United States—will be relatively modest in the first half of 2003 and accelerate in the second half of 2003, evening off in 2004. Oil prices are another variable of some interest in the current environment. Our base scenario is that oil prices (WTI) will average US$28 in 2003 and decrease to US$24 by the end of 2003—where they will more or less remain in 2004.

2003–04: FORECAST

Our forecast is for moderate real GDP growth in 2003, followed by solid growth in 2004. Overall, we expect real GDP to expand by 2.2 per cent in 2003 and at the much brisker pace of 3.6 per cent in 2004.

Domestic demand will remain the key driver of growth, driven particularly by personal consumption. Consumption is expected to grow by 3.2 per cent and 4.1 per cent in 2003 and 2004 respectively. More robust investment growth is anticipated, though the investment mix will change as interest rates rise. In particular, machinery and equipment investment is forecast to increase at about 2.5 per cent in 2003, and 5.6 per cent in 2004. The growth rate of residential construction, on the other hand, should fall to about 5 per cent in 2004.

Net exports are forecast to decline in both 2003 and 2004 in real terms. Real exports are forecast to fall by about 1 per cent in 2003 before recovering with growth of over 6 per cent in 2004. On the other hand, real imports will grow by over 5 per cent in 2003 and over 7 per cent in 2004. The divergence reflects expected external demand, relatively strong domestic demand, and the impact of the appreciation of the Canadian dollar. Despite these numbers, the current account surplus is forecast to expand to C$29 billion and slightly more than that in 2004. This result is attributable to an anticipated improvement in Canada's terms of trade.

All-items CPI inflation is forecast at 3.1 per cent in 2003 and 2.2 per cent in 2004. Core inflation will be less strident at 2.1 per cent and 1.9 per cent in 2003 and 2004 respectively. Approximately 220,000 new jobs are forecast to be added in 2003 (measured fourth-quarter to fourth-quarter), with the labour force expanding by a similar number. Thus we do not expect to see much improvement in the annual average unemployment rate in 2003. However, a divergence between job creation and labour force growth should open in 2004, implying a decline in the unemployment rate to just over 7 per cent.

MAJOR RISKS

Canada's growth outlook depends heavily on the outlook for external demand, particularly in the United States, our primary trading partner. Although the threat of a prolonged escalation in oil prices seems to have faded, it is worth noting that there are both direct and indirect impacts on Canada, all negative. The direct impacts on the price level, and hence possibly on monetary policy, will likely be at least partly offset by greater exploration and development activity and infrastructure expenditures, than might be the case in a low price environment. At the same time, the indirect impacts, transmitted to the Canadian economy via a dampening of growth in major trading partners, would probably have a much more chilling impact on the Canadian economy. A second risk that should be mentioned relates to exchange rates. Our forecast suggests that the C$/US$ rate will average about 1.42 in 2003, and 1.39 in 2004. If the Canadian dollar appreciation turns out to be more extensive than anticipated, the outlook may be negatively impacted. Finally, we do not consider either SARS or BSE (mad cow) disease to be a *significant* risk to the outlook. Although very distressing for those involved, both problems appear to be contained, and have been accounted for in the forecast.

Business investment in inventories (C$ million, chained)

Associated with the recession of the early 1990s was a string of 16 consecutive quarters in which inventories declined. The slowdown in late 2001 was accompanied by a relatively sharp inventory reduction. Accumulation returned in late 2002 and early 2003 to levels well above the average of the past decade. Inventory investment should slow as 2003 progresses and then accelerate in 2004.