THE CANADIAN CHAMBER OF COMMERCE

LA CHAMBRE DE COMMERCE DU CANADA

Canada – Economic Review and Outlook

Steady As She Goes For 2005 and 2006

After registering a 2.9 per cent advance in real GDP (on an average annual basis) in 2004, Canada's overall economy is expected to deliver a similar growth rate in both 2005 and 2006. Considerable variation in the growth patterns of regions is expected with economic growth remaining above 3.0 per cent in the western provinces and below the national average in central and eastern Canada.

2005 In Review

As 2005 comes to a close, economic momentum continues to vary across the country. Provinces in western Canada, namely Alberta, British Columbia and Saskatchewan, will top the provincial growth charts this year as surging energy prices have generated increased corporate profits, business investment, employment, consumer spending and housing activity. In contrast, manufacturing-intensive central Canada – Ontario and Quebec – has been under-performing as the appreciation of the Canadian dollar and rising energy costs have reduced the competitiveness of manufacturing exports.

Canada's overall economy is operating at full production capacity. Labour markets are tight and labour shortages are reported in many parts of the country and in a number of sectors. According to the Bank of Canada's autumn *Business Outlook Survey*, 51 per cent of firms surveyed reported that they face labour shortages that restrict their ability to meet demand. Indicative of an excess demand for labour, the unemployment rate fell to 6.4 per cent in November, its lowest reading since December 1974 and annual wage growth is accelerating at its fastest pace in 4 years. On the inflation front, total CPI inflation in November was up 2.0 per cent from a year ago, and the core rate of inflation[1], which rose 1.6 per cent from a year ago, remains remarkably tame at the present time staying below the Bank of Canada's 2.0 per cent inflation-control target. However, with the economy operating at capacity, longer-term inflation expectations appear to be well anchored.

In this environment, the Bank of Canada adopted a tightening bias in recent months to avoid a buildup of inflation pressures. On September 7, 2005, Canada's central bank increased its key policy interest rate, the target for the overnight rate[2], by 25 basis points to 2.75 per cent,

[1] The Bank of Canada's measure of core inflation excludes the 8 most volatile components of the consumer price index (CPI) – fruit, vegetables, gasoline, fuel oil, natural gas, mortgage interest, inter-city transportation and tobacco products – as well as the effect of changes in indirect taxes on the remaining components.

[2] The overnight rate is the average interest rate the Bank of Canada wants to see in the marketplace where major financial institutions lend each other money for one day or "overnight".

the first rate hike since October 2004. This was followed by two additional 25 basis point increases on (October 18 and December 6) taking the overnight rate to 3.25 per cent.

After trading in the 79 to 83 U.S. cents range for most of 2005, the Canadian dollar has been trading in a higher range since late summer. It is interesting to note that while most major currencies lost ground against the U.S. dollar over that same period, the loonie has been the exception. It even brushed off any concerns arising from the toppling of the federal government and uncertainty over the upcoming federal election, hitting its highest level versus its U.S. counterpart in almost 14 years on December 14 (87.51 U.S. cents). Higher energy prices, rising interest rates, and increasing cross-border merger and acquisition (M&A) activity that entails foreign buying of Canadian assets have all lent support to our currency. 2005 will also be viewed as the year when foreign exchange markets increasingly viewed the loonie as a "petro-currency" as our dollar has been closely following movements in crude oil prices. This should not come as a surprise because Canada is a net exporter of oil -- as energy prices rise, Canada's terms of trade increase and, therefore, its real income.

Outlook for 2006

Looking forward to 2006, the Canadian Chamber of Commerce is forecasting average annual real GDP growth of 2.9 per cent. This would place Canada second only to the United States among G7 nations in terms of growth.[3] Similar to 2005, and for the same reasons, the national growth rate will mask a divergence in regional growth patterns.

Overall, consumer spending is expected to continue to make a contribution to growth in 2006, albeit at a more modest pace than in 2005 as households burdened by rising fuel and heating costs cut back on discretionary purchases. Moreover, rising home prices and mortgage rates are expected to temper housing-related activity. In 2006, we look to the business sector and governments to do most of the heavy lifting. Solid gains are expected in business investment reflecting high rates of industrial capacity utilization in a number of capital-intensive sectors, extremely healthy corporate balance sheets – particularly in the resource sector – and earlier reductions in the prices of imported machinery and equipment thanks to a stronger Canadian dollar.[4] Non-residential construction activity is also expected to pick up reflecting multi-billion dollar investments in projects in Canada's energy patch and increased investment in commercial building construction. More expansionary fiscal policy by all levels of government (for example, increased government expenditures on infrastructure, and education and health care facilities, as well as tax cuts) is expected to account for a larger share of economic growth in 2006. Last, but certainly not least, the external side of the economy (i.e. real net exports) is also expected to make a contribution to GDP growth in 2006. Exports have already adjusted significantly to the appreciation of the Canadian dollar and indeed, according to Bank of Canada research, this adjustment process is largely completed.

The unemployment rate is expected to remain low – to average 6.6% in 2006, one of the lowest in decades – and labour markets tight supporting solid gains in wages and salaries.

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[3] The U.S. economy is expected to grow at an average annual real rate of 3.2% in 2006.

[4] Canadian firms import approximately 75 per cent of their machinery and equipment from the U.S. and the high Canadian dollar has made the acquisition significantly more affordable.

With the economy operating at full capacity and rising wage pressures, the risk of higher inflation is there. Total CPI inflation is projected to fluctuate in the 2.0-2.5 per cent (year-over-year) range in the first half of 2006 before returning to the Bank of Canada's 2 per cent inflation-control target in the second half of the year. The core rate of inflation is expected to gradually rise to 2 per cent by mid-2006 and to remain there for the remainder of 2006.

In this environment, we look for the Bank of Canada to continue to raise its key policy interest rate, lifting the target overnight interest rate to 4.0 per cent by mid-2006, up from 3.25 per cent at present. Canada's central bank has stated on a number of occasions that the risks to the outlook are balanced over the short term, but are tilted to the downside as we look to 2007 and beyond. The principal risk relates to weaker global demand (including an anticipated slowdown in the U.S. economy) and the impact it will have on demand for Canadian exports and commodity prices. There is a strong hint here from the Bank of Canada that interest rates could decline in late 2006.

In the first quarter of 2006, we expect the Canadian dollar to continue to trend higher versus the U.S. dollar, peaking at close to 90 U.S. cents. The main reason: the U.S. currency is expected to come under renewed weakness by the spring of 2006 as two key factors supporting the U.S. dollar in 2005 unwind.

- The generally strong performance of the U.S. dollar in 2005 can be attributed, in part, to the provisions of the *American Jobs Creation Act of 2004*. The legislation, over a one-year period, allowed U.S. firms with overseas operations to repatriate their profits at a reduced tax rate of 5.25 per cent rather than the normal rate of 35 per cent. This has resulted in a heavy inflow to U.S. capital markets and has provided a boost to the U.S. dollar.[5] However, this temporary tax cut is coming to a close suggesting that this pillar of support to the greenback is coming to an end.

- Another pillar of support for the U.S. dollar will also fall to the wayside in early 2006. After 13 straight interest rate hikes by the U.S. Federal Reserve (25-basis points at a time), the Fed's tightening cycle is coming to an end. We believe that the U.S. Federal Reserve will raise its target for the federal funds rate by a cumulative 50 basis points by the end of the first quarter of 2006 to avoid falling behind the inflation curve.[6] This will take the fed funds rate to 4.75 per cent, up from 4.25 per cent at present. Meanwhile, the Bank of Canada's target for the overnight rate is set to climb to 4.0 per cent by mid-2006, up from 3.25 per cent at present. We also look for monetary tightening in many foreign economies (the U.K. and Japan, for example) over the course of 2006 as many central banks are discussing the possibility due to rising inflationary pressures. As the U.S. Federal Reserve's tightening cycle comes to an end early next year, interest rate differentials between the U.S. and other major economies (including Canada) will narrow. This will make U.S. assets less attractive relative to comparable assets abroad providing less support to the U.S. currency going forward. Once again, foreign exchange

[5] In the first nine months 2005, the flow of repatriated foreign capital increased by $225 billion. J.P. Morgan estimates that another $75 billion will return to America in the fourth quarter. The total amount is considerably more than what had been expected.
[6] Research has suggested that historically it takes 12 to 18 months for changes in interest rates to have most of their impact on output, and 18 to 24 months to have most of their impact on prices.

markets will return their attention to the massive and unsustainable U.S. current account deficit.[7]

However, after peaking in the first quarter of 2006, the Canadian dollar is expected to drift back through the course of 2006 ending the year at about 84 U.S. cents. This is largely a reflection of an expected pullback in commodity prices as the global economy slows, particularly in the U.S. and with some moderation expected in China. Energy prices, in particular, are expected to retrace a portion of their recent sharp gains and base metal prices are projected to fall moderately.

The risks and uncertainties to our base-case projections relate to future energy prices and their impact on exports, the exchange rate and inflation; and how the Canadian economy adjusts to global developments, including strong competition from newly industrialized economies, like China and India.

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[7] The U.S. current account deficit was US$783.3 billion in the third quarter of 2005 (on an annualized basis) which represented a whopping 6.2 per cent of GDP. In contrast, Canada's current account surplus remains a sizeable 2.7 per cent of GDP. The current account is the combined balances on trade in goods and services, income, and net unilateral current transfers. The U.S. economy is highly dependent on foreign capital inflows to finance current account imbalances. The risk is that foreign investors, investment funds and central banks could turn away from holding U.S. dollar and U.S. dollar-denominated assets in their portfolios resulting in a further fall in the U.S. dollar and/or a plunge in stocks and bonds and soaring interest rates. Fed Chairman, Alan Greenspan, asserts that rising interest rates and a falling U.S. dollar will be a requirement for continued funding of the U.S. current account deficit.