CANADA

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2003: DOMESTIC DEMAND PERSEVERES

Reflecting on the year-end national accounts numbers, it is tempting to suggest that 2003 was a relatively unremarkable year for Canada. Built on solid consumption growth, a resumption of machinery and equipment investment, and a dash of government spending, the Canadian economy grew by 1.7% year-on-year. Inflation was an acceptable 2.7%, and decelerated late in the year. Canada enjoyed a fourth straight year with a current account surplus in excess of 2% of GDP. Ho hum.

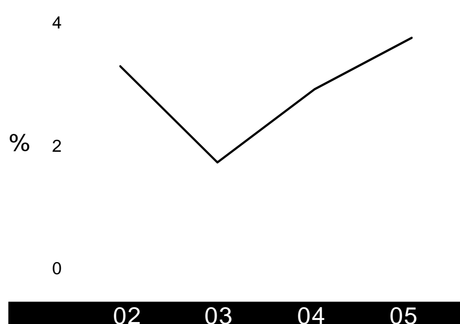
But the numbers attest more to the resilience of domestic demand than they do to an unremarkable year. Indeed, what is perhaps most remarkable about the year-end numbers is that they are so benign. 2003 was anything but ho hum. It was the year of SARS, the year that Canada discovered its first homegrown case of bovine spongiform encephalopathy (BSE), the year of the August blackout in central Canada, and the year in which the currency of our major trading partner depreciated at a double-digit rate against the Canadian dollar.

The economy reacted in very orthodox ways to each of these events. SARS killed more than 40 people in Ontario, and preventative measures kept thousands more from their normal routines. SARS also decimated tourist arrivals and the service industries they support, though the impact was not so neatly contained geographically.

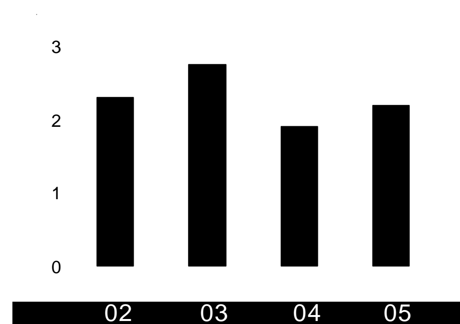
In May, BSE was discovered in a cow in Alberta. The impact on the beef industry was immediate and devastating. Many countries refused to accept imports of Canadian cattle and beef. The North American beef industry, akin to the car industry, features a rather high degree of integration, and cattle may cross the border several times before they are ultimately consumed. In 2002, Canadian beef exports amounted to approximately CA$4.1 billion, with 45% of that consisting of live animals. The corresponding figure for 2003 is CA$2.1 billion, with barely a quarter of the total accounted for by live animals.

Finally, 2003 saw an unprecedented appreciation of the Canadian dollar against the currency of its most significant trading partner, the United States. The dramatic movement in the exchange rate had a very significant impact on Canada's terms of trade. Real net exports fell significantly, from more than CA$55 billion in each of 2001 and 2002 to barely CA$31 billion last year. But despite the significant contraction of real net exports, the current account surplus expanded by a little over 10%. The expansion reflects both the impacts of exchange-rate driven price changes (import prices fell by 7% while export prices fell by 1%; *nominal* net exports were little changed from 2002) and a modest improvement in the investment income account. The income balance result is itself a reflection of the stronger dollar, as interest paid on non-residents' foreign currency denom-

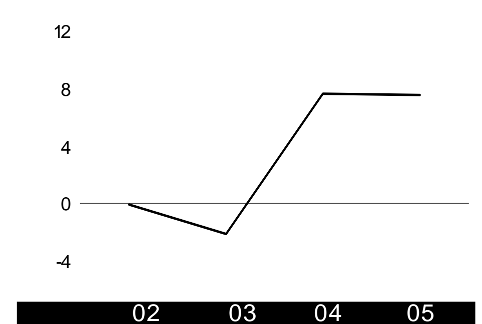
GDP growth



CPI inflation



Export growth



inated accounts, and debt service accruing to US dollar-denominated debt held by non-residents, declined in Canadian dollar terms.

2004–05

Our forecast for 2004 and 2005 is for two years of relatively solid growth, at 2.9% and 3.7% respectively. As was the case last year, in 2004, domestic demand will underpin the growth, with consumption expanding at about 2.9%. Business investment, especially in the machinery and equipment sub-aggregate, should pick up in 2004, reflecting a gradual tightening of capacity, continued low interest rates, and the impact of lower import prices. The heightened private investment will offset slower growth in government expenditure and investment.

The key difference between the outlook for 2004 and the experience of 2003 is that we anticipate that net exports will come in just about flat, rather than the sizeable negative contribution to GDP growth made by the external sector last year. The outlook for 2005 is similar to that for 2004, with slightly higher domestic demand growth being augmented by further improvement in net exports. Consistent with the anticipated changes in net exports, and with our exchange rate forecast, we expect a modest expansion in the current account balance in 2004 and 2005.

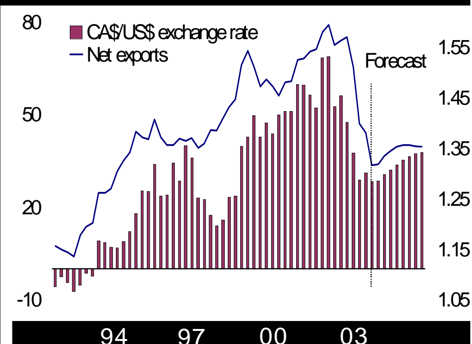
The CA$/US$ rate ended 2003 at approximately 1.30, well below the annual average for 2003 of just over 1.40. We expect that the CA$/US$ rate will spend most of this year and next between 1.30 and 1.36, with the 2004 full-year average coming in around 1.34. Thus the outlook is hardly bullish on the Canadian dollar (or bearish on the US dollar) although a comparison of annual averages might suggest otherwise. One key factor in our exchange rate forecast is our expectation that US monetary authorities will, over the two-year window in question, adopt a *relatively* tighter monetary stance. A second factor is commodity prices, where we feel the bulk of the gains have already been made. Rising commodity prices, other things being equal, typically benefit the Canadian currency.

All-items CPI inflation is forecast at 1.9% in 2004 and 2.2% in 2005. Core inflation will be less strident, coming in at 1.6% and 1.7% in the next two years respectively. The economy is forecast to add approximately 310,000 new jobs this year, with the labour force expanding by a slightly smaller number. Thus we expect only a modest improvement in the annual average unemployment rate in 2004, to 7.4%. The divergence between jobs creation and labour force growth should widen a bit in 2004, implying a further decline in the unemployment rate.

We anticipate slightly slower government expenditure growth this year and next. Late in 2003, Jean Chretien retired and was replaced as Prime Minister by Paul Martin. Martin was Finance Minister during Canada's federal fiscal consolidation in the mid 1990s, and he is loathe to do anything that might tarnish his reputation for fiscal conservatism. His first budget, as expected, kept new spending to a minimum.

The exchange rate and net exports

Although the relationship is not perfect, the association between movements in net exports(shown in the chart in units of billions of chained Canadian dollars) and the CA$/US$ exchange rate seems clear.



RISKS TO THE FORECAST

A perennial risk factor in the Canadian outlook is the outlook for the United States. Our forecast is conditioned on growth in the United States of 4.5%–5% in 2004, and a more moderate though still robust 3.5%–4% in 2005. There are both upside and downside risks in the US outlook, with commensurate Canadian exposure. We note that there are many channels through which such impacts might occur, including trade and investment flows, and financial variables like interest rates and exchange rates.

A second source of uncertainty lies in commodity prices, which have (as measured in US dollars) been quite robust. However, that commodity price strength has come at a time of US dollar weakness against the Canadian dollar. The net (direct) impact on Canada depends upon which of these influences is stronger. Canadian dollar strength compresses net exports. At the same time, higher commodity prices are a boon to producer profits, and lead to greater exploration and development expenditures. The Bank of Canada prepares a commodity price index weighted to reflect Canadian commodity production. Between January 2003 and January 2004 that index rose by 15% in US dollar terms. However, in Canadian dollar terms, it *fell* by almost 4%, meaning that, on average (and ignoring the impacts of hedging programs), Canadian commodity producers' margins were being squeezed. In addition to the direct impact, there is also an indirect impact stemming from the possible growth-dampening effect that higher commodity prices could have in other economies, especially the United States. Thus the overall impact of unanticipated commodity price strength depends in part upon contemporaneous exchange rate changes, but are likely to be negative.