2 CANADA

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2004: DOMESTIC DEMAND CARRIES THE DAY

2004 was a relatively good year for Canada overall. Built on robust consumption growth, solid machinery and equipment investment, and a still very strong housing market, the Canadian economy grew by 2.8% year over year. At 1.9%, inflation was a shade under the Bank of Canada's 2% target. Trade in goods and services expanded briskly. And Canada enjoyed a fourth straight year with a current account surplus in excess of 2% of GDP.

However, the annual figures hide some weaknesses that are more apparent in the quarterly numbers. After a strong start, the economy softened through the third and fourth quarters, with the bulk of the slowdown resulting from falling export receipts. Expressed in annualized terms, exports declined by more than 3% in each of the last two quarters of the year. Over those same two quarters, imports grew at a double-digit rate. Also worth noting is the important role played by inventory accumulation in the second half, with the Q4 and Q3 increases respectively representing the largest and third-largest quarterly results of the past four decades. The inventory expansion likely reflects not only the unintentional build-up resulting from export weakness but also intentional growth related to concerns about the cost and stability of input supply. Shipping and port bottlenecks, commodity scarcity and price rises, and an increasing use of inputs sourced offshore combined to induce firms to hold higher levels of inventory than they might normally do. Thus the net export weakness and robust inventory builds seen in the second half can be interpreted as two sides of the same coin.

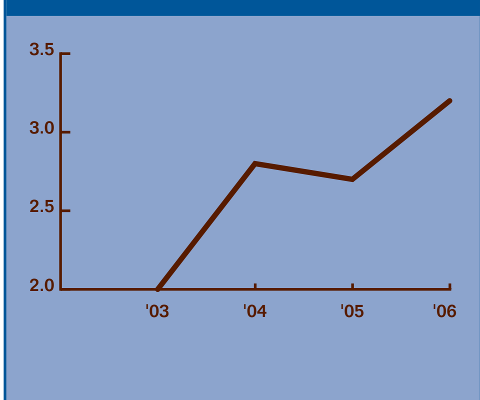
One influence behind the export weakness was the strength of the Canadian dollar, which followed a dramatic 2003 appreciation against the currency of the country's most significant trading partner, the United States, with more of the same. After remaining in the 1.30-1.375 range for most of the first eight months of the year, the Canadian dollar once again began to appreciate in earnest in September, moving to a low point near 1.18 — meaning a peak-to-trough US dollar depreciation of almost 16% against the Canadian unit between mid-May and late November. On an annual basis, the 2003 US$ depreciation amounts to a more reasonable but still meaningful 7%. The C$/US$ rate had moved from 1.575 at the beginning of January 2003 to 1.204 by end-2004. Canada has not experienced an appreciation of this magnitude in the modern era.

The dramatic movements in the exchange rate (and in commodity prices) have had a very significant impact on Canada's terms of trade. In real terms, net exports have fallen significantly, from more than C$55 billion in each of 2001 and 2002 to C$34 billion in 2003 and barely C$22 billion last year. Despite the significant contraction of real net exports, the current-account surplus has expanded in robust fashion, increasing by C$11 billion (about 0.7% of GDP) last year. The expansion reflects both the terms of trade impacts (import prices fell by 2% while export prices rose by a similar amount, meaning that despite the decline in real net exports, *nominal* net exports grew by almost C$10 billion) and a modest improvement in the investment income account. The income balance result is also a reflection of the stronger dollar, as interest paid on non-residents' foreign currency denominated accounts, and debt service accruing to US$-denominated debt held by non-residents, both declined in Canadian dollar terms.

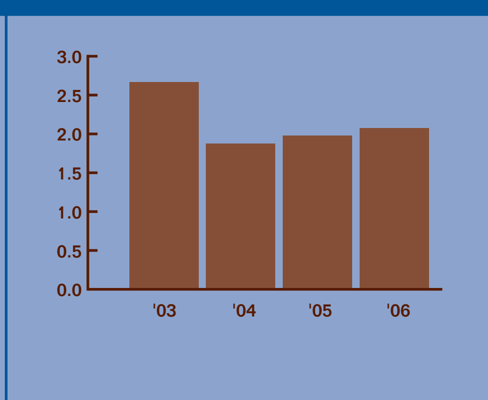
OUTLOOK FOR 2005 AND 2006

The RBC Economics forecast for 2005 and 2006 is for two years of relatively solid growth, at 2.7% and 3.2% respectively. As was the case last year, in 2005 domestic demand will underpin the growth, with consumption expanding at about 3.7%. Investment should have another strong year in 2005, reflecting several factors, including a gradual tightening of capacity, continued low interest rates, ongoing strength in commodity prices, and the influence of the stronger dollar on the prices of imported capital goods. Recent investment

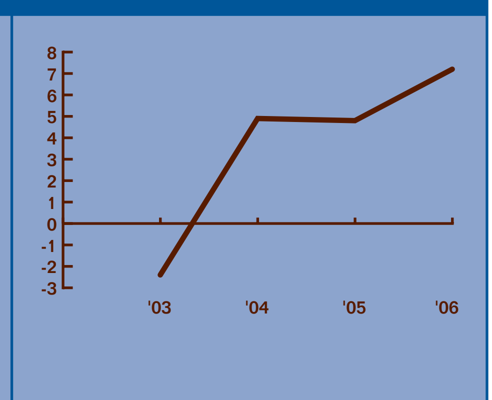
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



intentions survey data lend support to this interpretation. The heightened investment will more than offset a return to much lower levels of stock building. Government expenditures and investment are also expected to accelerate over the coming two years.

Net exports will continue to make a negative contribution to GDP growth. This will reflect two key factors: continuing adjustment to the Canadian dollar appreciation and somewhat slower (though still quite solid) growth in the United States. In real terms, Canada's trade surplus will have essentially disappeared by the end of 2006. In fact, it has all but done so already, with the final quarter of 2004 generating annualized net exports of only C$5 billion (down from C$37 billion in Q2). Seen in this light, it is clear that while net exports will be a significant damper on growth in 2005, it is also fair to suggest that the most significant impacts (at least as measured by net exports) are, or soon will be, past us.

The outlook for 2006 is quite similar to that for 2005, albeit with a gradual deceleration of domestic demand growth. On an annual average basis, net exports will continue to act as a drag on growth, although with much smaller impact in 2006 than in 2005. However, viewed quarter over quarter, net exports are expected to begin making positive contributions to growth by the second quarter of 2006.

The C$/US$ rate is projected to spend most of this year and next between 1.17 and 1.29, averaging 1.22 this year and finishing 2006 at around 1.29. One factor in the exchange rate forecast is the anticipation of relatively more aggressive tightening of monetary policy in the US, and a second is the expectation that while commodity prices will remain relatively robust, they are not likely to move appreciably higher on average.

All-items CPI inflation is forecast to hover around the Bank of Canada's target of 2% in both 2005 and 2006. The economy is expected to add new jobs at a 1.6% growth rate this year, with the labour force expanding at a slightly slower rate. The divergence between jobs creation and labour force growth should widen a bit in 2006, pushing the unemployment rate down below 7% for only the second time in the past decade. The improving jobs picture will reflect not only the solid growth prospects, but also growing capacity utilization levels in the US and a corresponding increase in demand for Canadian goods and services.

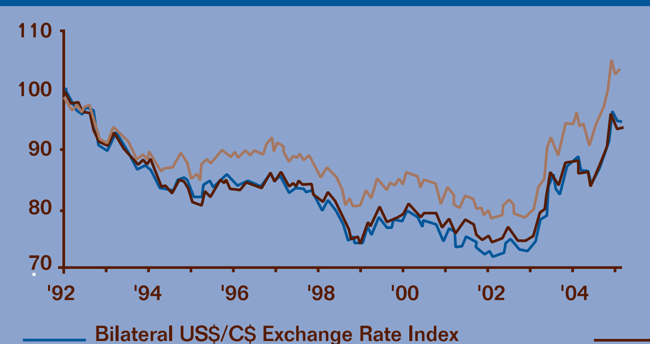
RISKS TO THE FORECAST

A perennial risk factor in the Canadian outlook is the outlook for the US. There are many interrelated ways one can come at this — US current account deficit rationalization, further US$ weakness, or the possibility that the US consumer will significantly scale back consumption growth — but each would imply a measure of downside risk for the outlook. That said, expectations are for growth in the US to be slightly slower this year than last, and a further modest slowing in 2006. A positive US growth surprise would translate into upside risk in the Canadian forecast.

The outlook is predicated on commodity prices retaining much of their recent gains. Rapid commodity price movements, which could result from a number of influences including geopolitical instability, shifting sentiment regarding emerging market growth prospects, or further currency realignments, would have a significant impact on the current account, and possibly also on exchange rates. Depending upon the nature of the underlying shock, such movements might also be associated with adjustments in real variables, especially investment.

Finally, the ongoing process of adjustment to the impacts of a stronger currency, and the potential for another bout of exchange rate movements, represent a risk to the forecast. Initially, the impacts of the appreciation were somewhat muted, reflecting robust external demand, high commodity prices, and the offsetting impacts of hedges, both financial and "natural." This gave way to more meaningful adjustments as the rise in commodity prices and external demand growth slowed, prior contractual and hedging arrangements expired, and firms began incorporating the stronger currency into their strategic planning and operational decisions. Business survey data compiled by the Bank of Canada suggest that heightened import competition and narrower export margins are leading an increasing number of firms to exit certain business lines, locate operations offshore or source additional inputs from abroad, or to engage in additional productivity-enhancing investment. The Canadian outlook is conditioned on these anticipated adjustments to the recent currency realignments. However, renewed US$ depreciation beyond that reflected in the forecast would represent another source of downside risk, potentially stalling the net export recovery.

THE CANADIAN DOLLAR'S REBOUND



Movements in trade-weighted and real C$/US$ indexes are highly correlated with movements in the C$/US$ nominal exchange rate, reflecting the substantial role played by the US in the Canadian trade profile, and the broadly similar inflation experiences in the two countries. As the accompanying chart illustrates, approximately a decade of trend Canadian dollar depreciation was almost entirely unwound in the space of two years. While some firms have welcomed the appreciation, those that benefited from the weaker Canadian dollar — whether or not internationally active — have little choice but to adjust.