THE CANADIAN CHAMBER OF COMMERCE
LA CHAMBRE DE COMMERCE DU CANADA

2014-15 Economic Outlook

Policy Brief

Economic Policy Series – December 2013

Introduction

Canada's economy is on track to expand by 1.7 per cent in 2013, matching the previous year's sluggish pace. Consumer spending and housing activity are proving more resilient than expected, while the slow pace of global growth and ongoing competitiveness challenges have reduced demand for our exports and weighed on manufacturing production. At the same time, businesses remain cautious when it comes to hiring and investing.

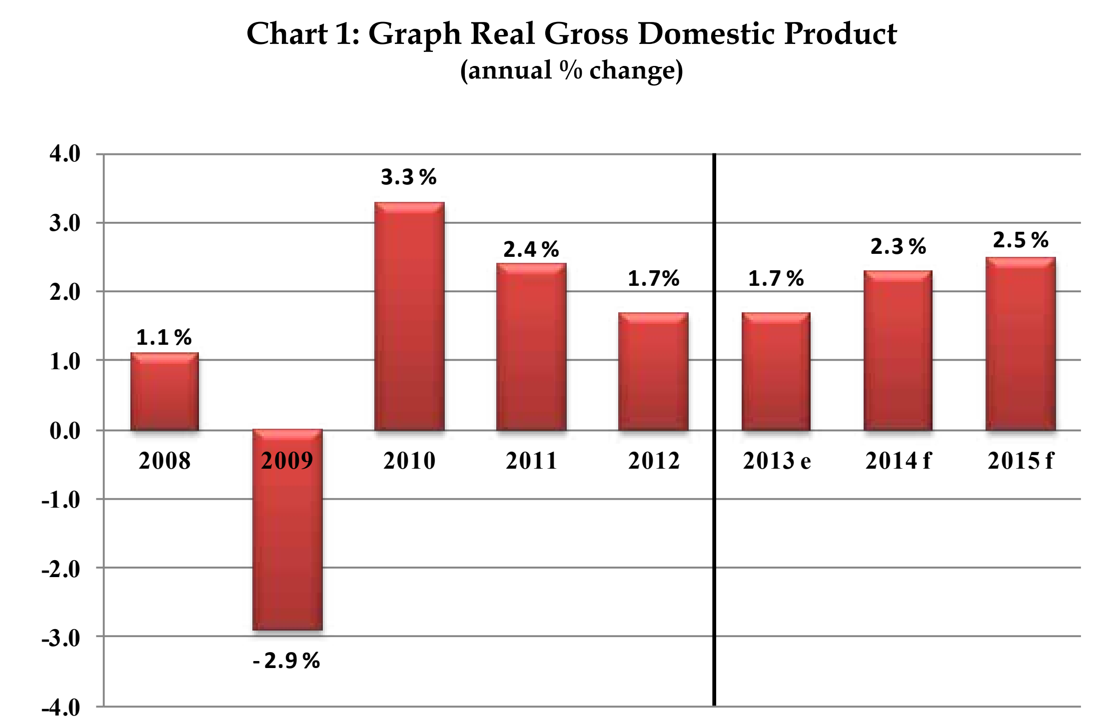
The economy is projected to grow by 2.3 per cent in 2014 and strengthen moderately to 2.5 per cent in 2015. With households and governments reining in debt, we look to stronger exports and business capital spending to spark stronger growth over the next few years. This is predicated on the expectation that economic growth will accelerate in the U.S. and gradually pick-up in Europe. When businesses

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.

see demand picking up, they will have greater confidence to invest in productivity-enhancing machinery and equipment and expand production capacity.

To reap the full benefits of an improving global outlook, we must strengthen our competitiveness, tap new markets and secure and grow our involvement in global supply chains.



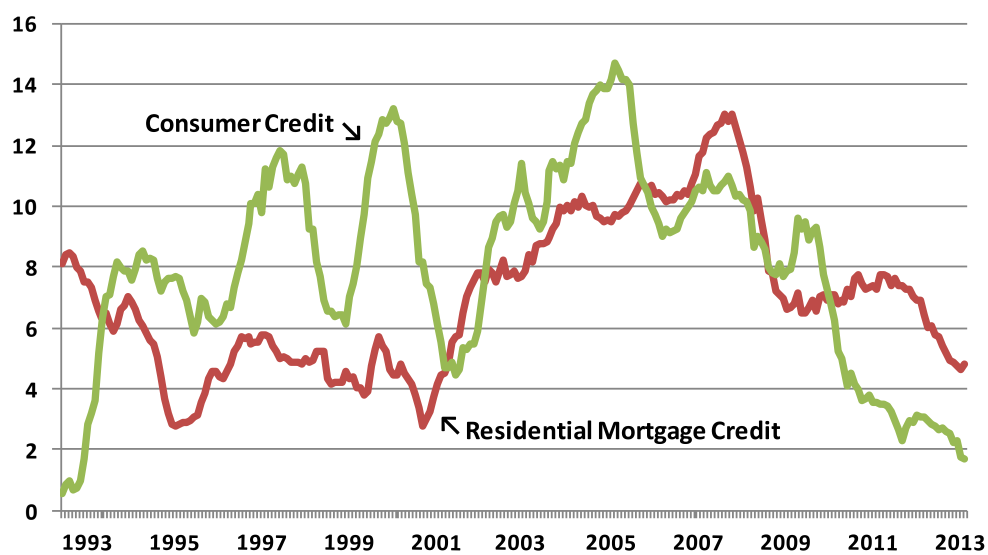
Source: Statistics Canada; The Canadian Chamber of Commerce.
e = estimate; f = forecast

Don’t Bet Against the Consumer

Consumer spending has remained a stalwart supporter of growth in Canada. Retail sales have been surprisingly robust, especially so in light of modest job gains, lacklustre wage growth and slowing household credit growth (see Chart 2).[1] Consumers are clearly willing to spend on big ticket items. Auto dealers are having their best year ever thanks to improving vehicle affordability and very attractive sales incentives, including cash-back offers and cut-rate financing. Housing-related retailing, including furniture and building materials, has also been doing well, driven by ongoing gains in existing home sales.

Consumer spending is expected to increase at a moderate pace—about 2.4 per cent per year—over the forecast period (i.e. 2014-2015). That would be roughly consistent with 2013’s pace, but below the average growth rate registered over the 2000 to 2012 period (i.e. 3.0 per cent). This recognizes that consumers have become a little more cautious in their spending as reflected in the personal saving rate that is well above the average recorded over 2000 to 2012 period.[2] The anticipated moderation in household consumption also reflects an expectation of moderate gains in employment over the forecast horizon—certainly a bit cooler than in recent years—but enough to reduce the unemployment rate to 6.7 per cent by year-end 2014 and to 6.5 per cent by year-end 2015.[3]

Chart 2: Household Credit Growth
(% change, year-over-year)



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

1 Consumer credit includes credit card loans, personal lines of credit, auto loans, and other personal loans.

2 The household saving rate is defined as household saving as a percentage of household disposable income. In the third quarter of 2013, it increased to 5.4 per cent. Over the 2000-2012 period, it averaged 3.4 per cent.

3 Approximately 12,600 net new jobs were created per month, on average, in the first 10 months of 2013, about half the pace set in 2012. Looking ahead into 2014, net job creation is expected to average 10,000 to 15,000 jobs per month.

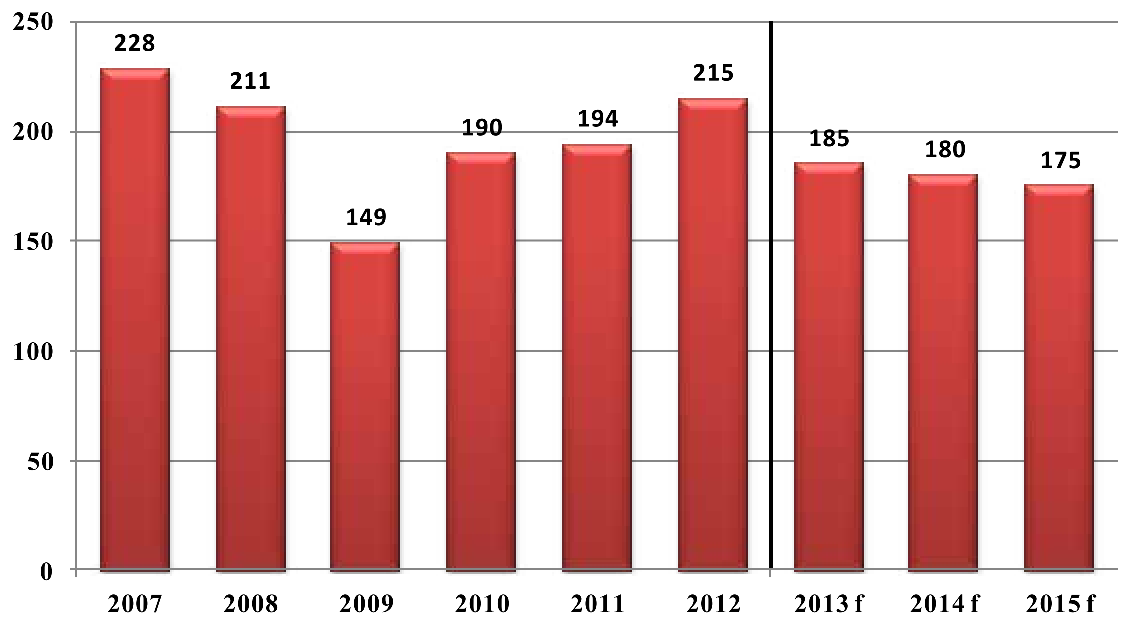
Canada's Housing Market Still Proving Resilient

Canada's housing market has continued to be source of strength for the economy. Home sales surged during the spring-summer as homebuyers jumped into the market to beat higher mortgage rates. While national sales have moderated somewhat since then, conditions vary considerably from city to city.

Modestly higher mortgage rates and stretched housing affordability will likely dampen home buyer enthusiasm in 2014, while steady demand from echo boomers (the children of baby boomers) and international migration will provide ongoing support. Prices, sales and starts should remain relatively steady in the year ahead.

On an annual average basis, housing starts are projected to average 185,000 units in 2013 and are forecast at 180,000 units in 2014 and 175,000 units in 2015.

Chart 3: Housing Starts ('000)
(seasonally adjusted at annual rates)



Source: Canada Mortgage and Housing Corporation; The Canadian Chamber of Commerce.

Government Spending Will Make Little Contribution to Growth

Federal and provincial governments are reining in spending to balance their books. The federal government projects it will return to budgetary balance by fiscal 2015-16. Four provinces are forecasting a balanced budget for fiscal 2013-14, and the rest are targeting balanced books for fiscal 2014-15 with the exception of Ontario; it is aiming to achieve balance by fiscal 2017-18.

With the focus on fiscal restraint, government spending will provide little support to overall growth in 2014 and 2015.

Net Exports to Contribute Positively to Growth

Trade has been a significant drag on economic growth in Canada. Exports have essentially stalled in the past two years and have yet to recover all the ground lost during the recession (see Chart 4). The weakness reflects sluggish global demand, over reliance on slower growing markets and ongoing competitiveness challenges.

In 2013, emerging-market economies will account for 82 per cent of global growth, yet only 12 per cent of Canada's merchandise exports go to faster growing emerging markets.[4] The good news is Canadian exporters continue to diversify their markets and are willing to tap the global marketplace. According to Export Development Canada's (EDC) semi-annual survey, one-third of all companies surveyed indicated that they had already started exporting to new markets in the last two years, and about half revealed that they have plans to expand into new foreign markets over the next two years. When asked about which new countries companies planned to export to in the next two years, the top five countries were Brazil (12 per cent), China (10 per cent), Germany (nine per cent), the U.K. (eight per cent) and Mexico (seven per cent).[5]

4 Remarks by Tiff Macklem, Senior Deputy Governor of the Bank of Canada, to the Economic Club of Canada. Toronto. October 1, 2013.

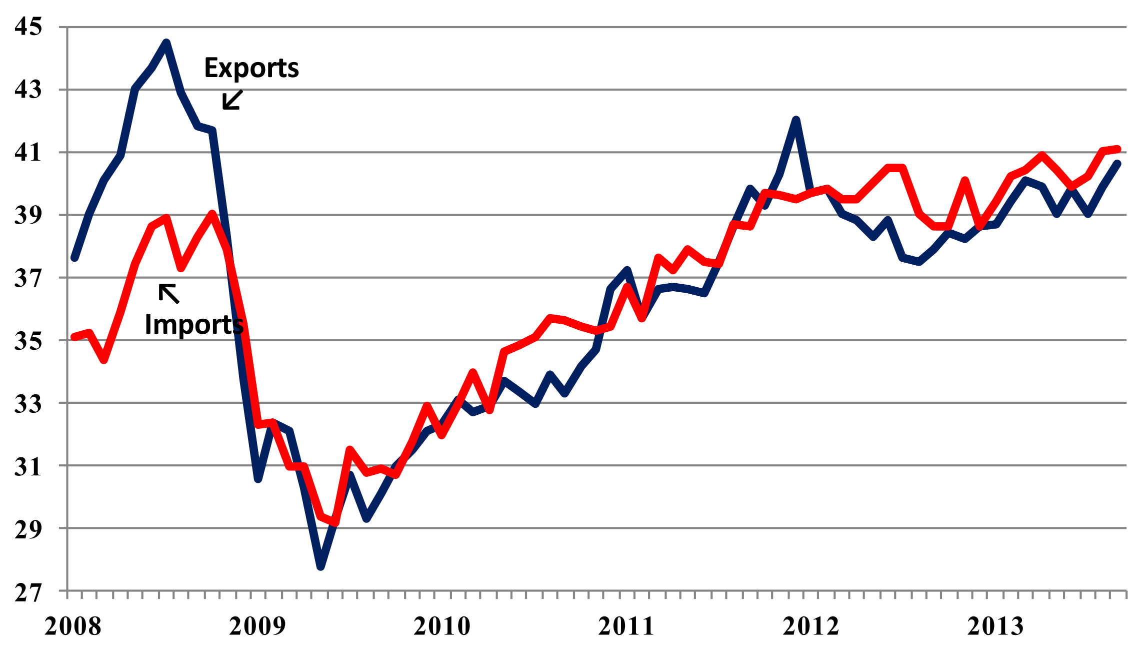
5 Export Development Canada (EDC). "Exporter confidence ticks up, less pessimism about Europe and world markets: EDC survey." *News Release*. June 27, 2013.

Looking ahead, Canadian businesses that export to the U.S. (the destination for 73 per cent of Canada's merchandise exports), including exporters of lumber, raw materials, consumer durables and machinery and equipment, should benefit from ongoing improvement in U.S. consumer demand, residential construction and business investment. A weaker Canadian dollar will also help exporters.

Finally, the euro area economy is seeing the infancy of a frail recovery, but it will be some time before economic conditions normalize. A gradual improvement in economic conditions in Europe will also benefit Canadian exporters as roughly nine per cent of Canada's merchandise exports go to western European countries. In due time, Canadian exporters will benefit from increased regional diversification as the Comprehensive Economic and Trade Agreement (CETA) agreement between Canada and the European Union is phased in.

Overall, net trade is expected to be a positive contributor to economic growth over the forecast horizon.

Chart 4: Graph Canadian International Merchandise Trade
(C$ billion, seasonally adjusted)



Source: Statistics Canada; The Canadian Chamber of Commerce.

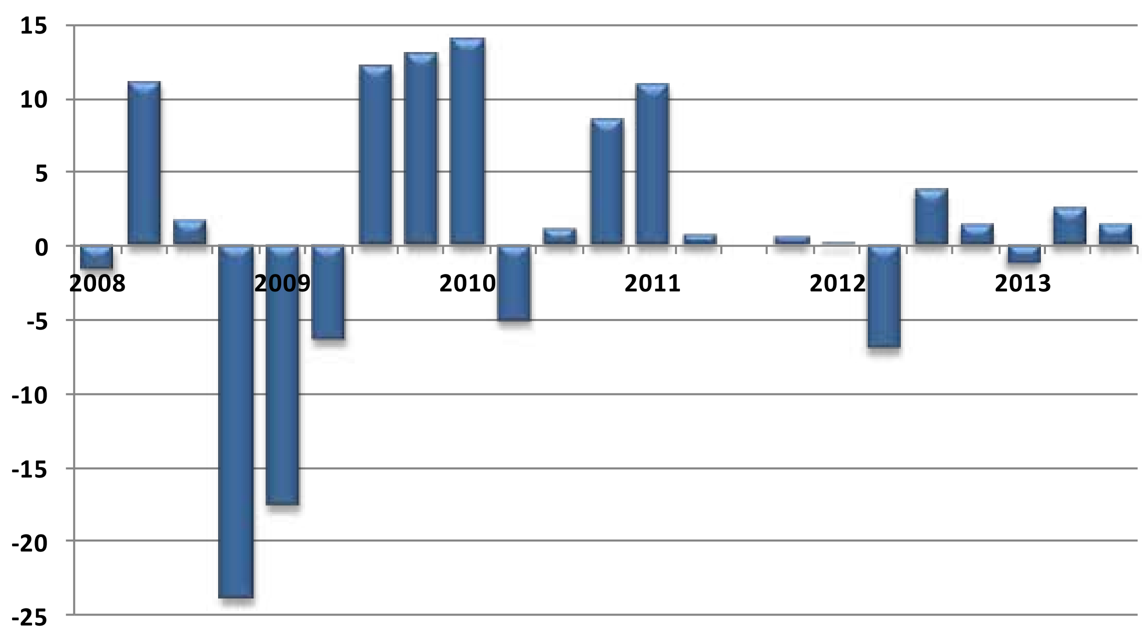
Businesses Leaders Are in Wait-and-See Mode

Softer corporate profits have affected business capacity to invest (see Chart 5), notwithstanding exceptionally strong corporate balance sheets and favourable financing costs. Many firms continue to report that uncertainty regarding future demand is affecting investment plans, leading them to postpone some projects or to focus on less risky initiatives (for example, repairing and replacing existing equipment). They are also shifting their investment spending toward new or different segments of demand.[6]

Business investment in plant, machinery and equipment is expected to pick up as the global economic landscape continues to improve and uncertainty subsides. Typically, business investment increases following a pick-up in exports, with a bit of a lag.[7] Historically, and on average, a one-percentage point acceleration in U.S. demand has led to a full three-percentage point increase in capital expenditures by Canadian corporations.[8]

Finally, non-residential construction is expected to remain fairly robust, and elevated commodity prices should continue to sustain a high level of capital spending in the resource patch.

Chart 5: Canadian Corporations—Quarterly Change in Operating Profits
(% change, year-over-year)



Source: Statistics Canada; The Canadian Chamber of Commerce.

6 Bank of Canada. "Business Outlook Survey." October 11, 2013.

7 Within two to four quarters following a rise in exports. Source: Bank of Canada.

8 Tal, Benjamin. "Why Corporate Canada Will Surprise on the Upside in 2014." *In Focus*. CIBC Economics. October 21, 2013.

Inflation Continues to be a Non-Issue for the Canadian Economy

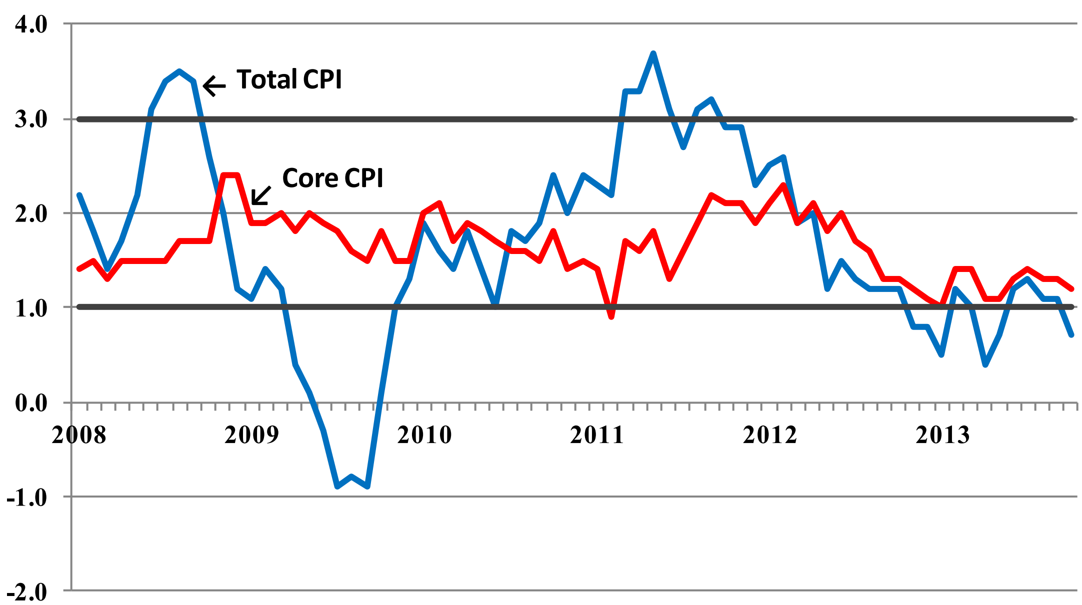
Headline inflation, as measured by the All-items Consumer Price Index (CPI), has generally been falling since May 2011, reflecting a highly competitive retail environment and significant amount of slack (spare capacity) in the economy. The Bank of Canada's closely watched core measure of inflation, which 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.

Inflation expectations remain well anchored. Overall, 97 per cent of businesses expect inflation to stay within the Bank of Canada's 1.0 per cent to 3.0 per cent inflation-control range over the next two years.[9]

The Bank of Canada expects both core inflation and total CPI inflation to increase gradually and return to the 2.0 per cent target around the end of 2015.

Faced with below-target inflation, modest growth and slowing household credit growth, the Bank of Canada has held its key policy rate at 1.00 per cent for more than three years and is in no hurry to increase rates. Indeed, it has stopped warning about future rate hikes. In turn, markets have pushed back rate hike expectations. We now think Canada's central bank will wait until early 2015 to start raising rates.

Chart 6: Consumer Price Index
(year-over-year percent change)



Source: Statistics Canada; The Canadian Chamber of Commerce.

9 Bank of Canada. "Business Outlook Survey." October 11, 2013.

The Canadian Dollar Is Expected to Trend Lower

At the start of 2013, one Canadian dollar bought 1.015 U.S. dollars. Since then, the loonie has lost roughly eight per cent in value against the U.S. dollar, and the near term outlook for the Canadian dollar has weakened. Some of the fundamentals that supported the Canadian dollar over the last several years have eased, most notably portfolio inflows into Canada have slowed and investors have pushed out their anticipated timing of the first rate hike by the Bank of Canada.

As the U.S. Federal Reserve begins tapering its monthly asset purchases,[10] we expect a broadly stronger U.S. dollar and a slightly weaker Canadian dollar. The loonie is generally projected to trade in the low 90 U.S. cent range in 2014. It should receive a boost in 2015 with the first rate hike by the Bank of Canada projected for early 2015. The loonie should strengthen to around 97 U.S. cents by year-end 2015.

10 Economists and several primary dealers polled by Reuters in early November leaned toward the U.S. Federal Reserve reducing its asset purchases in January 2014. The Fed has been buying $85 billion per month in Treasuries and mortgage-backed securities to lower the cost of borrowing to stimulate growth and to add liquidity to financial markets. This has put downward pressure on the U.S. dollar.

In Summary

The International Monetary Fund (IMF) projects global growth at 2.9 per cent in 2013, rising to 3.6 per cent in 2014 and 4.0 per cent in 2015. Much of the pickup in growth is expected to be driven by advanced economies. The Organisation for Economic Co-operation and Development (OECD) expects the world economy to grow at a 2.7 per cent rate in 2013 before accelerating to a 3.6 per cent rate in 2014 and 3.9 per cent in 2015. It, too, expects advanced economies to lead the pack.

"The strengthening in the pace of global economic activity is based on a lengthening list of growth-reinforcing factors and is long overdue. The most important factor is the re-emergence of the United States as the growth leader in the high-income advanced world and its potential to outperform expectations after a multi-year period of underperformance."[11]

A reinvigorated U.S. (and global) economy should translate into better prospects for Canada's export sector. To reap the full benefits; however, we need to strengthen our competitiveness, tap new markets and secure and grow our involvement in global supply chains.

Canada's share of the U.S. import market has declined steadily since 2000. Much of the loss in competitiveness reflects the strength of the Canadian dollar, but Canada's weak productivity performance has also played a significant role.

Government can play an instrumental role in strengthening competitiveness by improving the policy setting—for example, reducing the regulatory burden, cutting high marginal personal income tax rates, shifting away from taxing income and profits to taxing consumption, investing in infrastructure and education, and championing unencumbered global trade and investment—however, the onus is on businesses to craft a sustainable competitive advantage to capitalize on these opportunities. To boost their competitiveness, businesses must relentlessly focus on enhancing their operational efficiency and on reducing costs, continually upgrade the skills of their workforce, constantly improve their products and services, work with government to penetrate new markets, invest in R&D and in information and communications technology, and build internationally recognizable brands.

Because Canada's exports depend in varying degrees on imported inputs (goods and services), its capacity to import world class inputs is just as critical to its competitiveness and success in international markets as is its capacity to export. As such, managing supply chain relationships and leveraging global supply chains is a business imperative.[12]

On February 11, 2014, the Canadian Chamber of Commerce will launch its 2014 iteration of its *Top 10 Barriers to Canadian Competitiveness*—a major advocacy and outreach initiative focused on addressing 10 key impediments to Canada's competitiveness. We urge all our members to continue to actively support this important initiative and we look forward to sharing our successes with you.

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11 Scotiabank. "Cue The Strengthening Global Recovery, Again." Scotiabank Economics. October 31, 2013.

12 Kremmidas, Tina. "Reevaluating Canada's International Trade: The Impact of Global Supply Chains." *Economic Policy Series*. The Canadian Chamber of Commerce. May 2013.

For further information, please contact:
Tina Kremmidas, Chief Economist | tkremmidas@chamber.ca | 416.868.6415 ext 222

Upside and Downside Risk to the Outlook

This report provides the Canadian Chamber of Commerce's baseline projections. It is important to note that there are a range of upside and downside risks to our outlook. We judge these risks to be fairly balanced.

A budget deal to avert another U.S. government shutdown in mid-January and to raise the debt ceiling before the February 7 deadline would certainly bolster U.S. consumer and business confidence and kindle business investment and household spending. This would be very positive for Canadian exporters. On the other hand, failure to avert another government shutdown would dampen confidence and delay the U.S. expansion and Canada's anticipated export-led rebound.

Additionally, there is a risk that another flare-up in Europe would lead to a sudden loss of confidence, cause credit spreads to widen and equity and commodity prices to fall—all of which would have a negative impact on Canada.

We also need to be concerned about trouble spots like the Middle East. An escalation of geopolitical tensions would send crude oil prices sharply higher causing the global expansion to stall. Canada would most certainly feel the effects.

Domestically, there are risks related 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. The good news is households are taking action to improve their finances—growth of household credit has continued to slow and repayment of mortgage principal has increased.

Finally, there is the risk of a correction in house prices. The most likely scenario is one where prices, sales and starts stabilize.