

It's the Economy, Still

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With Canada facing the possibility of yet another federal election this fall—the fifth this decade, but who's counting?—the economy would clearly be the top campaign issue. The nub of the debate would likely take the following broad outline: *Point*: Canada has suffered heavily during the recession, with a broad array of indicators deteriorating much more sharply than officials expected in the past year, including the disappearance of our coveted twin surplus position. *Counterpoint*: Canada has held up well in the face of unprecedented global financial and economic turmoil, both relative to most other countries and versus previous recessions. Here are some of the specific arguments that we may hear on the glass half-empty/half-full debate:

On GDP Growth: *Point*: Canada has just suffered through a 3.3% drop in GDP in the past three quarters, its most severe downturn over such a short span in at least the past 50 years. The 3.4% annualized decline in Q2 for Canada was the worst performance in the G7, and growth may continue to lag behind the U.S. in the next two quarters. As a point of contrast, our commodity cousins in Australia have managed to avoid a technical recession altogether.

Counterpoint: Even with the Q2 drop, Canada still recorded one of the lightest hits in the industrialized world over the past year (Chart 1). The decline was serious, but relatively brief and not out of line with the early 1990s in terms of depth. It was also less severe than the early 1980s, even as the global economy was dragged into the worst slump of the post-war era. Timely and appropriate policies prevented a Great Recession here.

On Employment: *Point*: The unemployment rate has jumped nearly 3 percentage points in a year to its highest level in 11 years. Employment has dropped by almost 400,000 (or 2.3%) since last October alone, with factory payrolls plunging by more than 11% in the past year. The summertime unemployment rate for students was the highest on record, and the ranks of those receiving employment insurance have jumped 73% in the past year.

Counterpoint: Job losses have been only half as severe as the U.S. in percent terms this cycle (Chart 2). The 8.7% unemployment rate is not particularly high on a long-term basis, close to its 30-year average (of 8.6%). Job losses have been lighter than the two prior recessions, when the jobless rate rose well into double-digits. And, a higher

CHART 1
GLOBAL GDP: WORLD OF DIFFERENCE

2009:Q2 (y/y % chng)

Real GDP

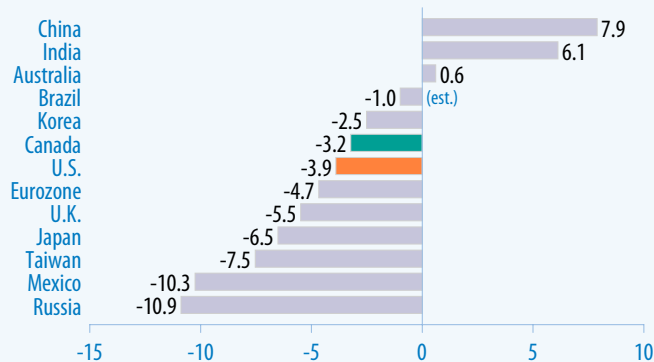
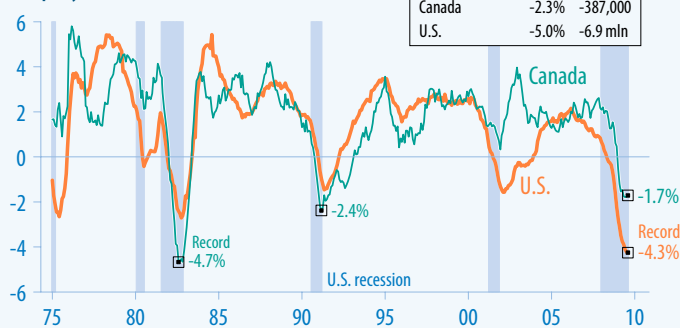


CHART 2
JOB LOSSES IN PERSPECTIVE

(y/y % chng)

Employment

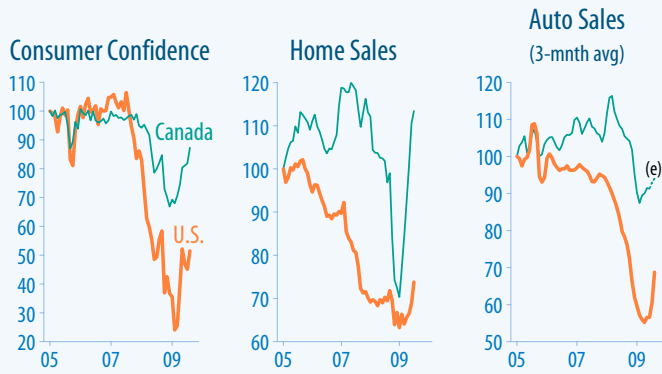


U.S. Recession Much Worse This Time

Cumulative Chng in Recession	%	Level
Canada	-2.3%	-387,000
U.S.	-5.0%	-6.9 mln

CHART 3
CANADIAN SPENDING HOLDS UP

(January 2005 = 100)



(e) = estimate

TABLE 1
DECONSTRUCTING THE DOWNTURN

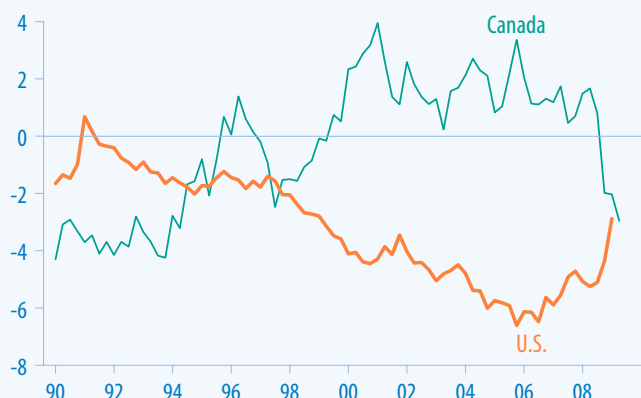
2009:Q2 (real terms : y/y % chng)

	Canada	U.S.
Consumer Spending	-0.5	-1.8
Government Spending	3.1	2.4
Business Investment	-16.4	-20.0
Housing	-11.5	-25.5
Final Domestic Demand	-2.6	-3.8
Contribution*: Net Exports	+0.8	+1.1
Inventories	-1.7	-1.0
GDP	-3.2	-3.9

* (share of GDP)

CHART 4
CURRENT ACCOUNT: TRADING PLACES

(% of GDP)



share of the unemployed are now receiving EI benefits (51% in June versus an average of 44% in the past 10 years), partly reflecting measures to make the system a bit more generous during the downturn.

On Domestic Spending: *Point:* The stimulus package has been ineffective, and much too slow to get underway. Consumer spending remains weak, and home building has taken a huge step back in the past year.

Counterpoint: Canadian domestic demand has held up better and is rebounding more quickly than in the U.S. right across the board (*Chart 3* and *Table 1*). Real government spending has actually risen more in Canada than in the U.S. over the past year. Partly thanks to the first-time homebuyer and renovation tax credits, housing demand has rebounded forcefully and spending is already recovering.

On Trade: *Point:* Canada has sunk into a merchandise trade deficit for the first time since the 1970s, and the broader current account shortfall was larger than in the U.S. as a share of GDP for the first time in more than a decade in Q2 (*Chart 4*). Ottawa has been unable to effectively fend off U.S. protectionist pressures. Meantime, Canada has not made significant inroads into the two countries that are still growing robustly—sales to China and India still only account for 3.7% of our exports.

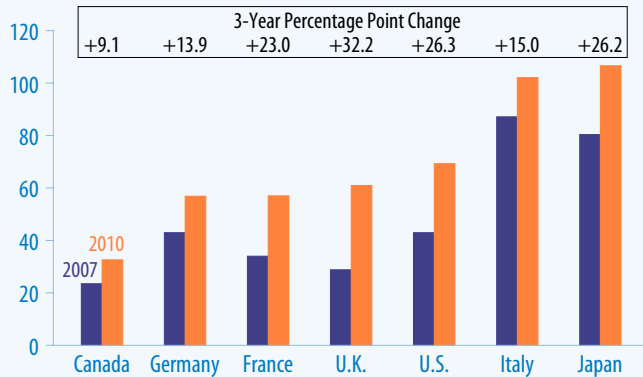
Counterpoint: The flip side of a relatively healthy domestic consumer is that imports have stabilized, while exports have been hit by forces beyond the control of policymakers, naturally weighing on the trade balance. And, the share of exports to China and India has more than tripled since the 1990s.

On Budget Deficits: *Point:* The federal budget has swung from a small surplus to a \$50 billion deficit (3.3% of GDP) in little more than a year, the first red ink in a decade. Ottawa completely misread the severity of the downturn in last fall's economic statement, and again underestimated the recession in January's budget. Adding in the provinces, Canada's total government deficit is now almost half as large as the gaping U.S. shortfall as a share of GDP.

Counterpoint: Almost every jurisdiction in the world has faced the same fiscal pressures in this cycle. Canada's net government debt will still be by far the smallest in the G7 as a

CHART 5
NET GOVERNMENT DEBT: ALL IN THE SAME BOAT

(% of GDP)



Source: OECD, June 2009 Economic Outlook

share of GDP in 2010, and the increase since the crisis broke will also be the lowest (*Chart 5*). While it will require some real restraint to balance the budget in the years ahead, Canada will likely not require anything close to the draconian measures the U.S. will face. And this year's budget was based on a much more severe downturn than the private sector consensus was looking for at that time (of admittedly very fluid forecasts).

Bottom Line: Canada's fine fundamentals and sound financial system did not spare it from the severe global downturn, but did cushion the blow. Regardless of who is in power, the priority in coming years must be: 1) ensuring the recovery takes hold, then 2) repairing federal finances without resorting to tax hikes, while 3) focusing on strengthening Canada's productivity performance and competitiveness.

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