State of the Economy

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What's Inside:

In the wake of the terrorist attacks in the United States, the economic outlook for Canada has soured considerably. The disruption of the airline and tourist industries, slowdowns at the Canada-U.S. border, and widespread weakening in consumer confidence have all dampened prospects for a quick turnaround in the economy. Most analysts are suggesting that the events of September 11 will result in a 0.3 percentage point reduction in growth estimates for 2001 and about one percentage point for 2002. As a result, Canada will now likely experience zero or negative economic growth in the last half of 2001 and into the early part of 2002.

While the terrorist attacks clearly dealt a significant blow, it is important to remember that problems in the economy — both south of the border and here in Canada — were very much evident prior to September 11. Despite the claims of some observers that the economy was well on its way to recovery prior to the terrorist attacks, the evidence shows that the slowdown in the second quarter and into the summer was far deeper and more serious than first realized.

Economic growth in Canada in the second quarter of 2001 was weaker than most analysts had anticipated. Real GDP advanced just 0.4% on an annualized basis, and real personal income fell 5.6% , erasing the gains made in the previous quarter. Corporate profits fell 6.4%, with operating profits in the non-financial sector posting their largest drop in over three years. Growth in labour income inched ahead just 1.9%, the smallest gain in five years. Meanwhile, consumer spending slowed to just 1.1% and investment in residential housing grew a very modest 0.4% (annual rate).

National accounts

	1999	2000	2001 Q1	2001 Q2
GDP $1997 (chained millions)	966,362	1,009,182	1,024,082	1,025,177
% real GDP growth (annual basis)	5.1	4.4	2.0	0.4
GDP $1997 per capita	31,691	32,819	33,172	33,124
Personal disposable income per capita ($1997)	18,860	19,230	19,813	19,390
Labour income (% of GDP)	52.6%	52.1%	50.6%	50.7%
Pre-tax corporate profits (% of GDP)	9.1%	10.6%	12.4%	12.2%

While final third-quarter numbers were not yet available at the time of publication, there is every indication to suggest the slowdown became more pronounced in the summer and before the impact of the terrorist attacks was felt. Real GDP fell in July over the previous month, and edged up just 0.1% in August. Exports rose just 0.2% in July after posting double-digit gains throughout the previous year. In August, the value of Canada's merchandise exports fell to their lowest level in 17 months, with big losses in machinery and equipment exports leading to an overall 3.4% drop from July. Employment fell by 0.2% between May and August. From December 2000 to October 2001, the economy generated just 28,000 net jobs, following a gain of about 380,000 jobs in 2000. The unemployment rate has risen from a low of 6.6% in June 2000 to 7.3% in October 2001. Retail sales softened in July over the previous month, and remained weak in August.

Based on the most recent labour force survey, it is clear that employment conditions have remained weak. The unemployment rate rose to 7.3% in October, its highest level in more than two years. Among the provinces, British Columbia has been the hardest hit. Employment declined 14,000 in October, bringing the province's total losses this year to 52,000 (-2.4%) and pushing the unemployment rate up to 8.2%. Employment has also fallen in Ontario, with job losses since May totalling 29,000.

A weaker job market has meant that earnings have also softened. Adjusted for inflation, average weekly earnings fell 2% between

Evidence of a Downturn, Summer 2001

	July 2001 % change since		**August 2001 % change since**	
	previous month	1 year ago	previous month	1 year ago
Real GDP at basic prices	-0.1%	0.4%	0.1%	0.4%
Industrial production	0.0%	-3.5%	0.1%	-3.2%
Manufacturing output	-0.5%	-4.9%	0.1%	-4.6%
Unemployment (percentage point change)	0.0	0.2	0.2	0.1
Retail Trade	-0.5%	3.4%	0.3%	3.6%
Composite index (percentage point change)	0.0	1.7	0.1	0.5
Exports	-0.4%	0.2%	-3.4	-4.4
Imports	0.0%	-1.3%	-0.8	-3.4

Labour Market Indicators (%)				
	1999	2000	Oct 2000	Oct 2001
Unemployment Rate	7.6	6.8	6.9	7.3
Men	7.8	6.9	6.9	7.6
Women	7.3	6.7	6.9	6.9
15-24 year-olds	14.0	12.6	12.9	13.0
25+	6.3	5.7	5.7	6.2
Participation Rate	65.6	65.9	66.0	65.9
Part-time rate	18.5	18.1	18.1	17.9
Self-employed rate	15.7	15.1	15.8	15.3
Unemployment rates by province				
Newfoundland	16.9	16.7	16.8	15.9
Prince Edward Island	14.4	12.0	13.5	12.4
Nova Scotia	9.6	9.1	9.4	9.7
New Brunswick	10.2	10.0	9.8	10.6
Quebec	9.3	8.4	8.4	8.5
Ontario	6.3	5.7	5.9	6.6
Manitoba	5.5	5.6	4.7	4.9
Saskatchewan	6.1	5.2	5.5	5.9
Alberta	5.7	5.0	4.7	4.5
British Columbia	8.3	7.2	7.6	8.2

July 2001 and July 2000. Average hourly earnings declined by roughly the same amount, with those employed in manufacturing seeing an average 2.9% decline in hourly earnings when adjusted for inflation.

The Outlook for Recovery

Much of Canada's economic fortunes rest on riding the wave of a U.S. rebound in the near term. Unfortunately, the picture that is quickly emerging in the United States is that of an economy falling into recession. The Bureau of Economic Analysis confirmed in October what many analysts had expected: the U.S. economy contracted in the third quarter of 2001. Real GDP output fell at an annualized rate of 0.4%, the largest drop in more than ten years.

Moreover, the signs of a deepening and severe slowdown are widespread. Consumer spending has slowed dramatically, posting its smallest increase since the first quarter of 1993. Retail sales did rebound in October, but this was led mainly by special gains in automobile sales as manufacturers continued to offer financing incentives. The housing sector continues to weaken, with new home sales declining in August and September. Business investment is falling by double-digit rates and exports declined for the fourth quarter in a row. Even government expenditures have softened, growing by just 1.8% in the third quarter compared to 5.5% in the second quarter.

Steep job losses have now spread to all sectors in the American economy, pushing the unemployment rate up to 5.4% in October, its highest level in nearly five years. The half-a-percentage-point rise in unemployment recorded in October is the largest one-month jump since February, 1986. Since October 2000, when the unemployment rate bottomed out at 3.9%, 2.2 million American workers have lost their jobs.

What is particularly disturbing is that virtually all sectors of the economy are experiencing weaker employment. Earlier this year, job losses were largely concentrated in the manufacturing sector. In recent months, however, employment declines have become more widespread. Employment in services has fallen in three of the past four months, and October's loss of 111,000 jobs was the largest one-month decline on record.

The official view in Washington is that the current recession will be quick and relatively mild. This optimistic conviction rests primarily on the belief that an aggressive easing of monetary policy

Average weekly and hourly earnings (2000)

	1999	2000	July 2000	July 2001	% change July 2000-July 2001
Average weekly earnings					
Industrial aggregate	656.03	653.55	651.73	639.07	-2.0%
Manufacturing	801.37	794.52	794.89	777.47	-2.2%
Average hourly earnings					
Industrial aggregate	16.09	16.52	16.56	16.22	-2.1%
Manufacturing	17.76	18.18	18.06	17.53	-2.9%

Note: Starting with the January 2001 data, the Survey of Employment, Payrolls and Hours is now publishing its estimates based on the North American Industry Classification System (NAICS). The NAICS-based estimates are not comparable with the previously reported statistics that were based on the Standard Industrial Classification (SIC) of 1980.

will quickly re-start a sputtering economic engine. In all, the Federal Reserve has cut short-term interest rates by four-and-a-half percentage points since January. Real interest rates, when adjusted for inflation, are now negative.

It is true that, given the lags involved, monetary easing will have some positive stimulative impact in the months ahead. However, it is also clear that interest rate cuts are simply not having the quick impact first expected. Cutting interest rates seems to be less effective, likely because the current downturn appears to have been caused by excess investment rather than weak demand.

Given that there is little prospect for a quick turnaround in the U.S., most forecasters are now predicting that Canada will experience real GDP growth of about 1.5% this year and 1.7% next year. However, there remain a number of serious downside risks for these estimates. The possibility of further terrorist attacks on the United States or unexpected political instability in the Middle East will of course have serious economic consequences.

In addition, current forecasts tend in our view to underestimate the fiscal drag as a result of government spending cuts in Canada. Several provinces have already announced spending reductions to protect their budgetary balances, and others, handcuffed by balanced budget legislation, will have to follow suit. This will create a further drag on the economy and weaken the pace of the recovery.

As well, this is the first serious economic downturn since the federal government weakened the "automatic stabilizers" in the economy — those programs like unemployment insurance and social assistance that provide income support during slow periods of growth and help, to some degree, to stabilize demand. However, unemployment insurance — or "employment" insurance, as it is now known — has been seriously weakened in recent years. Eligibility requirements are tighter, qualifying periods are longer, payments are lower, and the duration of benefits has been reduced. Meanwhile, the federal government no longer shares the cost of social assistance with the provinces. This means that, as unemployment rises, more people will be forced to rely on social assistance, thus pushing up costs for the provinces. This added burden will have to be met by additional spending cuts.

For these reasons, it is prudent to assume that there will likely be a downward revision of the consensus forecast. For our analysis of the federal government's fiscal outlook, we assume real GDP growth of 1.3% this year and 1.5% in fiscal 2002 — 0.2% below the consensus forecast in each year.

As illustrated, the combined effects of slower growth and previously announced tax cuts will weaken the federal government's finances this year. However, the full impact of the current economic slowdown will not be felt until the next fiscal year. In the current fiscal year, Ottawa will likely record an underlying surplus of around $8 billion. Assuming that program spending rises only in line with inflation and population growth and that there are no added measures to stimulate the economy, the federal government will see a rapid deterioration of its finances in fiscal 2002. The underlying balance will fall to just $500 million, while in fiscal 2003 the government will record a deficit.

Given that there is still a great deal of fiscal manoeuvring room available this year, Ottawa would be wise to take advantage of this to put together a fiscal stimulus package that would help generate growth.

Federal Government's Fiscal Outlook (billions of dollars)

	1999	2000	2001 (f)	2002 (f)	2003 (f)
Revenues	165.7	178.6	173.4	171.4	176.3
Program spending*	-111.8	-119.3	-126.5	-132.1	-137.1
Public debt charges	-41.6	-42.1	-38.9	-38.8	-39.4
Underlying balance	12.3	17.2	8.0	0.5	-0.2
Contingency/Prudence	–	–	-3.0	-4.0	-5.0
Planning surplus/deficit	12.3	17.2	5.0	-3.5	-5.2
Closing debt	564.5	547.3	539.3	538.8	539.0
Real GDP growth rate (%)	3.5%	4.7%	1.3%	1.5%	3.0%
Revenues (% of GDP)	17.3%	16.9%	16.0%	15.4%	15.1%
Program spending (% of GDP)	11.7%	11.3%	11.7%	11.9%	11.7%
Debt/GDP ratio (%)	58.9%	51.8%	49.8%	48.4%	46.2%

**For fiscal years 2002 and on, it is assumed program spending rises in line with inflation and population growth only.*

The Need for Fiscal Stimulus

Thus far, Canadian officials have put much of their faith in monetary policy to kick-start the sagging economy. Short-term rates have fallen to forty-year lows, but there is good reason to doubt whether these rate cuts will provide sufficient economic stimulus to prevent a deeper downturn.

In an economy suffering from rising unemployment and low consumer confidence, providing businesses and consumers with cheaper money will not in itself be enough to lift us out of recession. There is no guarantee consumers will be willing to take on added debt or that the savings they reap from lower interest rates will necessarily simulate spending. Faced with weakening employment conditions and growing insecurity, many consumers may just pocket the savings.

For businesses, no matter how low interest rates are, they will only begin investing and expanding production when sales increase again. Without the prospects for increased revenue growth, businesses have no reason to undertake risky investments, no matter what the cost of money.

Similarly, across-the-board personal and corporate income tax cuts are unlikely to provide the needed fix, either. Like savings from lower interest rates, consumers may be reluctant to spend whatever tax windfalls they reap. This is to say nothing of the regressive nature of such tax cuts.

The argument put forth in favour of corporate tax cuts is that they encourage investment by lowering the cost of capital. As noted above, however, the cost of capital plays a relatively small role in determining investment decisions. What matters is the prospect of sales growth.

Consequently, only direct fiscal stimulus can generate the growth the economy needs now to prevent a deeper and more protracted recession. For a fiscal stimulus package to increase growth quickly, it needs to focus on spending increases and temporary tax rebates for modest-income households. Proposals for accelerated across-the-board tax cuts or further cuts to corporate and capital gains taxes simply will not provide the same degree of stimulus. A quick increase in government spending will produce a bigger bang for the buck, on a dollar-for-dollar basis, than a tax cut of a similar size.

A Proposal for Fiscal Stimulus

The Canadian economy needs both an immediate stimulus package that will increase demand in the short term, and a reinvestment in infrastructure and public programs that will improve our economic capacity in the long run. The program proposed here would see the federal government provide about an $11 billion boost to the economy — an amount equivalent to roughly 1% of GDP. Anything substantially less than this amount would be too little to have any significant impact on the economy.

Such a package would only be effective if the provinces do not offset increased federal spending with cuts to provincial budgets. It will therefore be important for Ottawa to ensure that stimulus measures either bypass provincial coffers entirely and end up in the hands of households, or that other initiatives require a provincial buy-in or cost-sharing.

A stimulus package of $11 billion would require the government to post a modest deficit in the current fiscal year. It is worth remembering, however, that it is sound fiscal practice to balance the budget over the course of a business cycle. By this measure, the government is exceedingly well placed, having recorded a cumulative surplus of $36 billion since 1997.

The main components of an effective stimulus package would include the following:

Unemployment insurance emergency aid. The most direct way to ease the economic downturn at this point is to take immediate measures to strengthen the unemployment insurance system. Job losses are quickly mounting, particularly in the hospitality, tourism and transportation sectors, but, as noted above, the unemployment insurance system is much weaker than it was during the recession of the early 90s. Many of those losing their jobs now will find that they are not eligible for benefits or that they are entitled to smaller payments over a shorter period. Measures must be taken to help those workers who are most affected by the current downturn.

The first step would be to strengthen the unemployment insurance system, if only as a temporary or emergency measure. This could be done by creating an emergency assistance fund to enrich benefits and extend coverage to those workers who are currently ineligible for benefits. The first step would be to implement a uniform eligibility requirement of 360 hours. Currently, in order to qualify for benefits, someone has to have worked for up to 960 hours during the previous 52 weeks. Given the temporary and contingent nature of many of those working in the industries hardest hit by the economic downturn, this requirement will disqualify a large number of those laid-off. Lowering the number of hours needed to quality to 360 will provide much-needed protection to those who need it most.

Secondly, the government should extend the period during which benefits are paid. Under the current rules, the benefit period ranges from 14 to 45 weeks, based on a complicated formula of hours worked, local unemployment rates, and past use of the program. The benefit period could be immediately changed to a standard one week of benefits for every 30 hours of work, up to a maximum of one year.

The estimated cost of these measures, if adopted beginning December 1 and continuing for one year, would be $7 billion. This would be financed by a $4.5 billion contribution to the fund in the current fiscal year, and a $2.5 billion contribution in fiscal 2002.

Investments in infrastructure renewal. After more than two decades of neglect, there are tremendous needs for a renewal of public infrastructure in Canada. Such an investment is not only important in the short term to generate jobs and stimulate the economy, but is also essential for the longer-term health and productivity of the economy. In particular, the federal government could use its surplus this year to invest in adequate and affordable housing and in an environmental infrastructure program.

In terms of affordable housing, the Canadian Federation of Municipalities estimates that $15 billion in capital grants are needed over the next ten years to meet the demand for affordable housing. To address this need and at the same time inject some direct stimulus into the sagging economy, the federal government should commit $1 billion in the current fiscal year to a flexible capital grants program that would assist provinces and municipalities in building new, affordable rental housing. This investment would generate significant economic benefits as housing construction is labour-intensive and has higher-than-average job spin-offs because of the intensive use of Canadian-made products and materials.

A National Environmental Infrastructure Program could also be implemented to address the need to upgrade municipal water and sewage treatment plants, clean-up contaminated sites, to modernize and expand public transit systems, and to retrofit municipal and local public sector buildings to higher standards of energy efficiency. For the current fiscal year, this program would require an investment of $1 billion by the federal government, to be matched by equal contributions of $500 million each from provincial and municipal authorities.

Immediate increase in GST and Child tax credits. While some economists have been calling for the government to stimulate the economy through an acceleration of personal and corporate income tax cuts, this is not the most effective way to stimulate growth in the short term. These measures disproportionately benefit higher-income earners and put less money in the hands of lower-

Stimulus program budget ($ billions)			
	2001-02	**2002-3**	**2003-04**
Income security			
Unemployment insurance emergency fund	4.5	2.5	--
Increase in GST tax credit	2.8	–	--
$200 increase in child tax benefit	1.2	1.2	1.2
Public safety and security			
Public airport security	0.2	0.3	0.3
Infrastructure renewal			
National Affordable Housing Fund	1.0	--	--
Environmental Infrastructure Investment Program	1.0	--	--
Total	10.7	4.0	1.5

Fiscal Outlook with Stimulus Package (billions of dollars)					
	1999	**2000**	**2001(f)**	**2002 (f)**	**2003 (f)**
Revenues	165.7	178.6	175.4	175.9	181.1
Program spending*	-111.8	-119.3	-136.7	-136.1	-141.1
Public debt charges	-41.6	-42.1	-38.9	-39.4	-39.9
Underlying balance	12.3	17.2	-0.2	0.4	0.1
Contingency/Prudence	–	–	--	--	--
Planning surplus/deficit	**12.3**	**17.2**	**-0.2**	**0.4**	**0.1**
Closing debt	564.5	547.3	547.5	547.1	547.0
Real GDP growth rate (%)	3.5%	4.7%	2.0%	2.0%	3.0%
Revenues (% of GDP)	17.3%	16.9%	16.0%	15.5%	15.2%
Program spending (% of GDP)	11.7%	11.3%	12.5	12.0	11.9%
Debt/GDP ratio (%)	58.9%	51.8%	49.9%	48.2%	45.9%

income households who are more likely to spend tax savings and thus generate greater economic spin-offs.

Providing increases in the refundable tax credits — credits paid even if a tax filer pays no tax — are the best means of stimulating the economy and providing benefits to those really in need. The GST tax credit could be raised immediately and on a one-time basis by $200 for adults and $50 for children. Roughly 85% of these benefits would accrue to households with less than $25,000 in income. This measure would mean the maximum credit for a family of four would more than double to $909 in the current year. In addition, the government could immediately increase the child tax benefit by $200 per child, thus providing further assistance to low- and modest-income households. The cost of these two measures would be $4 billion.

Public airport security. In the wake of September 11, concern has been raised about the effectiveness of airport security measures both in the United States and Canada. Airport security should become a public safety responsibility. Public provision of these services can help restore confidence in the airline and travel industries. It would also provide some relief to the embattled airline industry which currently pays for security. The federal government should commit $200 million in the current fiscal year to invest in new security equipment and to train, equip and pay the salaries of airport security workers.

We estimate the effect of this stimulus package would be to boost real GDP growth to about 2% in the current fiscal year. Expending the contingency reserve to pay for the additional spending would leave the federal government with only a modest $200 million deficit. Under this scenario the government would record modest surpluses in fiscal 2002 and 2003. Importantly, the debt-to-GDP ratio would continue to decline and in fact would be lower in fiscal 2003 than under a stay-the-course scenario.

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