

State of the Economy

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CANADIAN CENTRE FOR POLICY ALTERNATIVES



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So far, so good

After slowing dramatically in the last six months of 2001, the Canadian economy has roared back to life in the first half of 2002. Canada led all G7 countries in the first quarter of 2002, with real GDP expanding by 6.2% on an annualized basis. Real GDP advanced at a 4.3% annualized pace in the second quarter. Job growth has been strong and consumer confidence has reached a 14-year high.

Consumers, buoyed by low interest rates, strong employment growth, and real gains in personal income, have been the driving force behind the gains posted this year. Overall first quarter retail sales were up 2.3%, but there are signs that retail sales may be slowing.

Labour income posted a respectable gain of 1.7% from the first and second quarter of 2002. Meanwhile, pre-tax corporate profits rebounded, but as a share of GDP remain well below the peak of 12% recorded in 2000.

Employment has grown steadily through the first seven months of 2002, rising by 2.2% or by nearly 327,000 jobs since December, 2001. The unemployment rate, however, has fallen only modestly from 7.9% in January to 7.6% in July as more Canadians entered the labour market. In spite of the impressive job gains posted this year, however, more than 1.2 million Canadians still remain without work.

Most of the jobs generated this year have been full-time, but part-time employment on a percentage basis has risen faster. Between

National accounts				
	2000	2001	2002Q1	2002Q2
GDP \$1997 (chained millions)	1,012,335	1,027,523	1,047,731	1,059,412
% real GDP growth (annual basis)	4.5%	1.5%	6.0%	4.3%
GDP \$1997 per capita	\$32,900	\$33,059	\$33,596	\$33,890
Personal disposable income per capita (\$1997)	\$19,647	\$20,001	\$20,115	\$20,137
Labour income (% of GDP)	50.4%	52.1%	52.5%	51.2%
Pre-tax corporate profits (% of GDP)	12.0%	10.8%	10.4%	10.9%

December and July, full-time employment has risen by 235,000 (+1.9%), while part-time employment increased by 91,000 (+3.3%). Consequently, the part-time employment rate — the share of workers employed part-time — has risen to its highest level since 1999.

With the rebound in the labour market, the number of hours worked has also risen steadily. Over the first half of the year, hours worked have increased by 2.2% to 33.7. This, however, is still well below the peak of 34.5 reached in January, 2001.

A stronger job market finally put more money in the pockets of working Canadians. Earnings have posted sustained improvements for the first time since 1999. Adjusted for inflation, average weekly earnings rose more than 3% between May 2001 and May 2002. Average hourly earnings also jumped by 3.6% over the same period, with the manufacturing hourly wage reaching a three-year

Labour Market Indicators (%)					
	1999	2000	2001	July 2001	July 2002
Unemployment Rate	7.6	6.8	7.2	7.0	7.6
Men	7.8	6.9	6.9	7.4	8.0
Women	7.3	6.7	6.9	6.6	7.2
15-24 year-olds	14.0	12.6	12.9	12.0	13.4
25+	6.3	5.7	5.7	6.1	6.5
Participation Rate	65.6	65.9	66.0	66.0	66.8
Part-time rate	18.5	18.1	18.1	18.3	18.4
Self-employed rate	15.7	15.1	15.8	15.3	15.9
Unemployment rates by province					
Newfoundland	16.9	16.7	16.8	15.2	15.0
Prince Edward Island	14.4	12.0	13.5	10.0	12.4
Nova Scotia	9.6	9.1	9.4	10.1	10.0
New Brunswick	10.2	10.0	9.8	10.5	10.5
Quebec	9.3	8.4	8.4	8.8	8.7
Ontario	6.3	5.7	5.9	6.0	7.2
Manitoba	5.5	5.6	4.7	5.4	5.0
Saskatchewan	6.1	5.2	5.5	5.6	5.3
Alberta	5.7	5.0	4.7	4.6	5.0
British Columbia	8.3	7.2	7.6	7.0	8.2

Average weekly and hourly earnings (2000\$)					
	1999	2000	May 2001	May 2002	% change May 2001- May 2002
Average weekly earnings					
Industrial aggregate	656.03	653.55	629.89	649.26	3.1%
Manufacturing	801.37	794.52	769.04	792.16	3.0%
Average hourly earnings					
Industrial aggregate	16.09	16.52	15.90	16.48	3.6%
Manufacturing	17.76	18.18	17.88	18.27	2.2%

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.

peak. However, when adjusted for inflation, both weekly earnings remain stubbornly below the levels recorded in 1999.

Nevertheless, there are some signs of weakness in the Canadian economy. While second quarter growth was strong, almost all the gains were recorded in April as GDP advanced 0.8%. Growth slowed to just 0.1% in May and June.

While the labour market remains strong, there are signs that private sector demand may be weakening. Businesses cut payrolls in July, signalling an overall restraint in expenditures. In fact, while public sector capital spending has recovered steadily after years of restraint in the 1990s, business investment remains weak. Statistics Canada's mid-year survey of future investment plans found little change from the start of the year. Overall, firms indicate they will be cutting investment by 2.1%.

Meanwhile, there are signs that consumer spending may be slowing. Retail sales declined in May, the third drop in four months. Auto sales have levelled off. And, although housing starts remain strong, the existing home market has shown signs of softening with a year-over-year retreat recorded in May and June.

Another potential blow to consumer confidence is the recent volatility in financial markets. While only the most affluent Canadians have been directly affected by the steep fall in share prices, many other Canadians are indirectly exposed to the stock market through pension plans and mutual funds. The strength in con-

sumer spending which drove economic growth in recent years was in no small part a result of consumers reducing their personal savings as stock market gains enriched their retirement savings. As long as share prices rose, lifting the value of retirement funds, households had little need to add to their retirement savings. With the recent fallback in the stock market, however, consumers may be in a mood to save more and spend less.

Household demand could also be negatively affected by possible interest rate increases. In September, the Bank of Canada surprised many observers by leaving its benchmark overnight rate unchanged after earlier signalling a likely rate increase. However, with the year-over-year inflation rate falling within the Bank's target range, the decision to keep rates unchanged was clearly the correct one. Real wage increases are in line with productivity growth and thus pose no threat to even the low inflation targets set out by the Bank. Raising rates at this time when business investment remains weak, when unemployment remains well above the lows recorded in 2000 and 2001, when the stock market remains volatile, and when the U.S. economy continues to struggle would risk cutting short the current recovery.

Continuing signs of weakness in the U.S.

In the United States, first quarter economic growth rose to its highest level since 1999, advancing at an annualized rate of 5.0%, but fell back sharply in the second quarter to post gains of just 1.1%. In retrospect, it appears that much of the first quarter gain was due to temporary improvements in business inventories following the slowdown of 2001. During last year's downturn, businesses cut production to clear unsold goods, thus sharply reducing growth in the fourth quarter. As inventories cleared, businesses restarted production in the first quarter. With inventories replenished, there was a reduction in production and weaker second quarter growth.

Consumer spending grew at just 1.9% in the second quarter, down from 3.1% in the first quarter. This softening reflects a weak U.S. labour market and a marked slowdown in wage growth. During the first six months of 2002, hourly manufacturing wages in the U.S. grew 3.4%, down from 4.1% one year ago.

The second quarter data also confirmed that there has been no recovery in business investment, as firms cut back capital expenditures another 1.6% following a 5.8% drop in the first quarter. The most recent decline in business investment represents the seventh straight quarterly decline in a row.

The U.S. labour market has also stalled, with the nation's unemployment rate remaining unchanged in July at 5.9%. Labour demand remains very weak, with mining, construction and manufacturing all posting declines in average weekly hours worked. Overall, average hours worked in the U.S. are now at their lowest level since the steep downturn recorded last October following the terrorist attacks of September 11.

The Outlook for Continued Recovery

The key issue facing the Canadian economy is whether it can continue to insulate itself from what appears to be continuing weakness in the United States. The conventional thinking, particularly in the wake of the FTA and NAFTA, is that any problem south of the border is sooner or later bound to spill over into Canada.

It is true that an extended slowdown in the United States will undoubtedly hurt the Canadian economy in the long term. However, domestic policy still has a role to play in fostering sustainable growth. One of the painful lessons of the early 1990s is that, while the recession gripped both Canada and the United States at the same time, a series of made-in-Canada policies made the decline more pronounced and protracted here. Excessively high interest rates and deep public spending cuts mired the Canadian economy in a severe recession even as the United States moved into recovery.

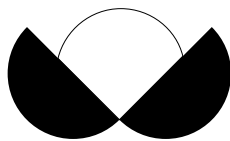
Nevertheless, on the strength of the first and second quarters, Canada's economy should grow 3.5% in this year, with some weakening expected in the second half of the year. On the federal fiscal front, Ottawa is likely poised to record a final year surplus of at least \$5.9 billion for fiscal year 2001. This is down substantially from the \$17.2 billion recorded in 2000 as the impact of the economic slowdown and the government's tax cuts reduced revenues. Based on an estimate of real growth of 3.5% this year, the surplus

Federal Government's Fiscal Outlook (billions of dollars)					
	1999	2000	2001 (e)	2002 (f)	2003 (f)
Revenues	165.7	178.6	174.7	181.0	186.1
Program spending*	-111.8	-119.3	-130.5	-136.6	-140.2
Public debt charges	-41.6	-42.1	-38.3	-38.4	-38.5
Surplus/deficit	12.3	17.2	5.9	6.0	7.4
Closing debt	564.5	547.3	541.1	535.4	528.0
Real GDP growth rate (%)	3.5%	4.5%	1.5%	3.5%	3.4%
Revenues (% of GDP)	17.3%	16.9%	16.0%	15.7%	15.3%
Program spending (% of GDP)	11.7%	11.2%	12.0%	11.8%	11.5%
Debt/GDP ratio (%)	57.9%	51.4%	49.6%	46.4%	43.4%

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

will remain in the range of \$6 billion in 2002. By 2003, however, Ottawa's surplus will likely grow to over \$7 billion.

These projections indicate that if the American economy continues to struggle and if the effects eventually do spill over the border, the federal government will be well placed to provide an additional fiscal stimulus to maintain economic growth. In the meantime, with a projected cumulative surplus of over \$19 billion over the next three years, Ottawa can focus its attention on beginning the urgent task of repairing the social infrastructure that suffered the most under the fiscal retrenchment of the past decade.



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