



Economic Commentary

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An Inconvenient Truth

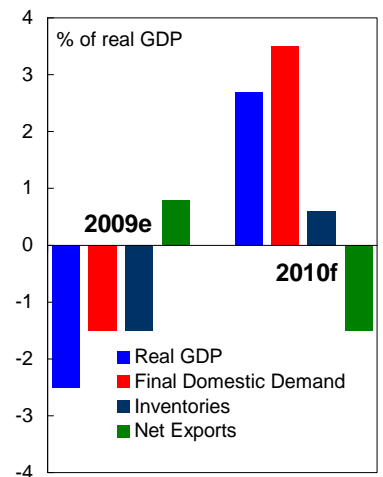
Just over a year ago, the Canadian economy fell off a cliff. National output plunged a gut-wrenching 3.3% from the 3Q08 peak in activity to the 2Q09 trough, a significant recession decline made even more acute by its relatively short nine-month duration. However, for all intents and purposes, the country's performance had been stagnating over the prior twelve months as well. Continuing gains in domestic-led activity were camouflaging a progressively worsening external trade performance as the weakening U.S. economy and a stronger Canadian dollar took an increasing bite out of our southerly-bound exports.

While many regions, sectors, and households are still feeling the recession's lingering impact, the Canadian economy actually began to dig itself out of its deep hole last spring. Although output posted a microscopic 0.4% annualized rate of growth in 3Q09, the renewed increase again camouflaged a much stronger 4.7% annualized advance in final domestic demand — the aggregation of consumer spending, residential construction, business investment and government expenditures. And last year's final quarter appears to be on a much stronger growth trajectory as continuing gains in domestic spending are being supported by a reduced pace of inventory destocking, and importantly, signs of reduced drag from foreign trade.

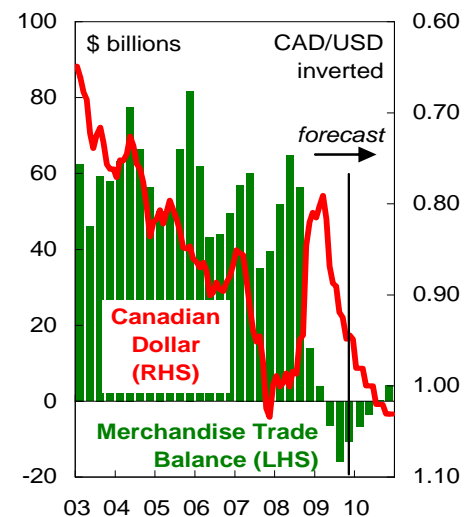
Much of the credit for this rather quick turnaround can be directed to policymakers who initiated 'pedal-to-the metal' monetary and fiscal support programs and stimulus to stop, stabilize, and eventually, reverse the wealth-sapping recessionary and deflationary undertow. Ultra-low interest rates have done much of the initial heavy lifting, facilitating balance sheet restructuring for households and businesses, and encouraging 'borrowing-to-buy' everything from homes and motor vehicles, to productivity-enhancing machinery & equipment. Governments right across the country — Ottawa, the provinces and municipalities — are reinforcing the renewed economic momentum through the massive expansion of public sector expenditures, a large component of which is directed to infrastructure upgrades that will support growth well into 2011.

Increasingly, however, there have been some unintended consequences here in Canada and around the world as a result of the highly synchronized and pro-growth policies undertaken, as well as market adjustments. From a Canadian standpoint, the housing market has been a big beneficiary of

Contribution to Canadian Real GDP Growth



Canada's Shrinking Merchandise Trade Balance



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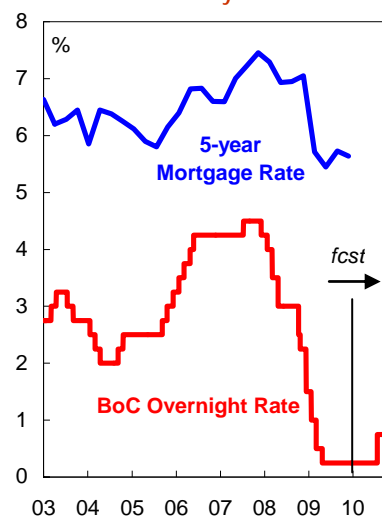
the reflationary policy thrust, with sales and prices moving sharply higher, and in some cases, posting record results. In addition, a much weaker U.S. dollar needed to help rebalance America's spending and saving dynamics, is triggering a significant competitive realignment domestically as export-sensitive firms adjust to the volume and profit-dampening impact of the stronger Canadian dollar.

To their credit, policymakers on both sides of Ottawa's Wellington Street — the Bank of Canada and the Federal Government — have provided regular economic updates to better inform Canadians about these challenging times, and the incipient recovery underway here at home and internationally as well. More recently, they have also become increasingly vocal on the potentially destabilizing economic consequences of escalating household indebtedness and an even stronger loonie.

But, policymakers find themselves between the proverbial 'rock and a hard place'. The Bank of Canada is conflicted by the prolonged period of ultra-low interest rates. Raising borrowing costs would undoubtedly go a long way to capping the inflationary consequences of the strong revival in housing activity, but higher rates would also exacerbate the deflationary consequences of a potentially stronger currency. Moral suasion to influence expectations may not go far enough under these extraordinary circumstances, suggesting that some form of policy tweaking may ultimately be required.

If the rise in household indebtedness related to the home sales boomlet is now of paramount concern, then let higher interest rates and market forces provide the necessary signals to Canadians and investors alike. Rising home prices have not yet bit, suggesting that affordability is still being tilted by the official commitment to ultra-low short-term borrowing costs, and to some extent, an investment preference for hard assets during this period of extraordinary volatility in equity markets, and low returns on money market and debt instruments. In this case, the Bank of Canada should signal that interest rates will be adjusted higher, albeit gradually, and sooner rather than later.

Canadian Interest Rates
Are Very Low



The Federal Government can also do its part. While prior pump-priming initiatives are supportive of the fledgling recovery under way, the government should use the upcoming March 4th Budget to provide a blueprint to repair its recession-battered fiscal finances. Households, businesses, and investors alike need to know which fiscal levers the government plans to adjust, by how much, and by when. As was the case in the 1990s, restoring fiscal flexibility is essential to buffer the Canadian economy from any further shocks in the future. But in this new decade, Canada must also be prepared to deal with the lengthening list of strategic issues — competitiveness, demographic, and environmental — that are fundamental to securing the country's longer-term performance.