



# Economic Directions

## The Long & Winding Road To Recovery

*Pre-Budget Submission to the Ontario Standing Committee on Finance and Economic Affairs*

### A Synchronized Global Retrenchment

**Warren Jestin, Senior Vice-President & Chief Economist**

Global economic activity is receding rapidly, despite unprecedented government actions to support credit markets and inject big doses of monetary and fiscal stimulus to revive consumer, business and investor confidence. The seismic shock delivered by the U.S. sub-prime fiasco to world financial markets has now triggered retrenchments in North America, Europe and Japan and has substantially undermined economic prospects in emerging economies. Global growth is unlikely to exceed 1½% in 2009, the weakest performance since the early 1980s.

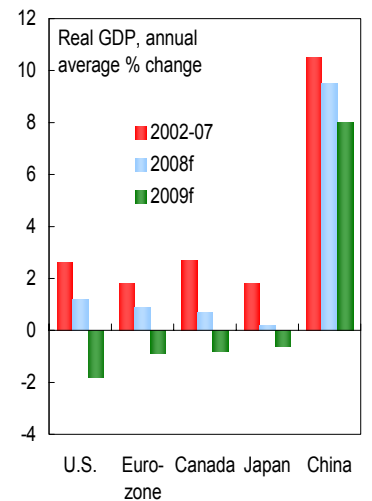
The U.S. economy contracted in the third quarter and will likely continue losing ground through much of 2009 before embarking on a protracted period of convalescence. The stabilization of the housing market and home valuations — an essential precursor to U.S. recovery — will be impeded by accelerating job losses and an overhang of unsold inventories equivalent to 10 months' sales. Export gains, until recently one of the few bright spots for Corporate America, are being circumscribed by weakening global activity. Reduced offshore earnings will also add to the squeeze on profits from falling domestic sales, triggering further big layoffs and cutbacks in business investment.

While high inventories have greatly exacerbated the U.S. downturn, the fundamental impediments to economic revitalization are structural, not cyclical. The powerful 'borrow-to-buy' driver of consumer spending over the past three years, fuelled by home equity withdrawals and financial innovation that allowed marginal borrowers to ramp up leverage, has been disengaged. It is being replaced by an 'earn-and-save-before-you-buy' dynamic that points to a prolonged period of deleveraging and subdued consumer spending.

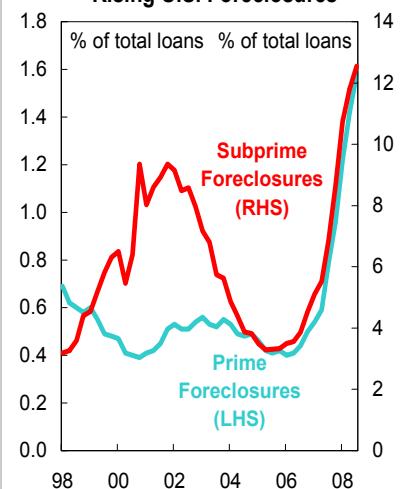
Washington is poised to deliver another huge dose of fiscal stimulus, this time focused on job-creating infrastructure projects and, in the case of the auto industry, on job-preserving support packages. While such action will help support U.S. domestic demand, it will take considerable time — and more than fiscal stimulus — to resolve the imbalances underlying depressed housing activity and the longer-term global market challenges confronting the Detroit Three. Pedal-to-the-metal U.S. government spending also will not reverse the broad-based slide in business profitability tied to a loss of growth momentum abroad.

The Federal Reserve also is in uncharted waters, dramatically expanding its balance sheet, accepting a broadening array of collateral and soon, moving its bellwether rate on overnight Fed funds even closer to zero. There are increasing signs that aggressive purchases of longer-term securities may be used to bring interest rates down across the yield curve. To date, the impact of this unprecedented monetary stimulus has been severely constrained by broad-based financial deleveraging and the deteriorating credit-worthiness of marginal borrowers. More generally,

**G7 Growth Stalls**



**Rising U.S. Foreclosures**





households and businesses will be very cautious about ramping up borrowing or spending in today's highly uncertain economic environment.

Policymakers in other major developed nations also have moved aggressively to cushion the slide in their economies. In Europe, the Bank of England and European Central Bank have cut their policy rates to historic lows. The Bank of Japan has moved back towards a zero interest rate policy. Mounting job losses also have underlined the need for immediate, aggressive fiscal action even as government deficits widen sharply. With economic retrenchment becoming more pervasive across sectors and more synchronized across nations, there is bound to be an escalation of pro-growth initiatives in the months ahead. However, as these actions begin to gain traction in stabilizing global financial and economic conditions, probably during the second half of 2009, policymakers will confront a new set of challenges.

This is particularly the case in the United States, where the Fed will need to move quickly to drain the flood of excess liquidity that has been pumped into the system before it drives inflationary expectations and bond yields sharply higher — a politically difficult task if the recovery is weak and uneven. Washington's current acquiescence to running deficits that will average at least one trillion dollars this year and next will limit future fiscal flexibility and, unless pared back, will ultimately pose clear risks to the U.S. dollar and the bond market. The bottom line — the U.S. road to recovery is likely to be long and winding, stretching well beyond 2009, with plenty of volatility in the U.S. dollar and bond markets along the way.

While economic conditions also have deteriorated in growth leaders such as China, India and Brazil, these nations appear to have enough resilience in domestic demand to continue outperforming the traditional developed nations by a wide margin. For example, China is still expected to generate growth approaching 8% in 2009 at a time when the G7 nations collectively will record declining output. A more pronounced deceleration in emerging nations would have serious consequences for commodity producers and exporters of high-tech and infrastructural products, primarily headquartered in North America, Europe and Japan.

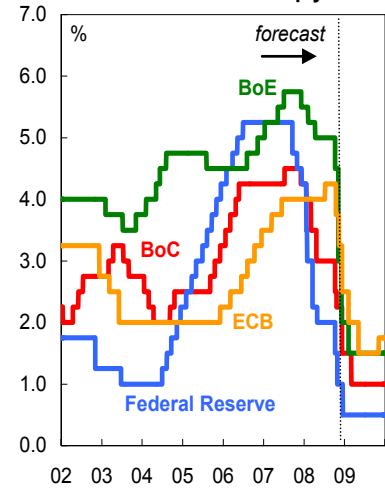
While the home-grown risks to the outlook vary across nations, the process of rejuvenating global growth and re-establishing confidence in financial markets requires policy co-ordination among both developed and emerging nations. Agreement among G7 nations, often hard to achieve, is not enough because the new growth leaders are providing much of the world's locomotion and control enormous pools of financial assets. President Bush's decision to invite the heads of state of all G20 nations to meet in Washington during November to discuss ways of dealing with the global crisis reflects that reality.

**Canada's Prospects — Caught In The Global Downturn**

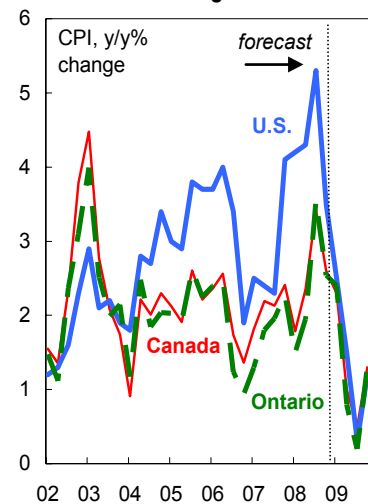
The Canadian economy lost considerable momentum over the summer, with output in the third quarter up only half a per cent from a year earlier. Prospects for resource-rich provinces have deteriorated as faltering demand from emerging markets triggered a sharp fall in prices for oil and most industrial commodities. By November, Canadian motor vehicle sales were running 10% below the previous year. Housing starts and sales also have fallen to the lowest levels in more than half a decade.

In explaining its latest three-quarter percentage point rate cut, bringing the Bank Rate to a fifty-year low of 1.5%, the Bank of Canada indicated that our economy is in the process of joining other major industrial nations in recession.

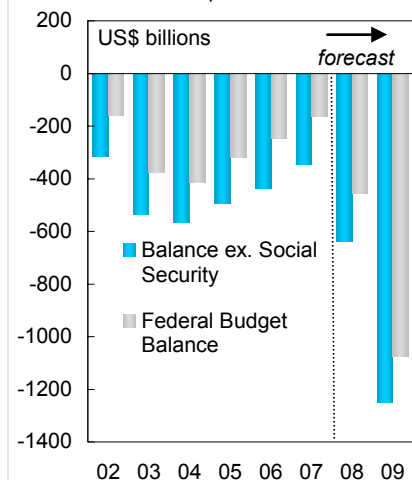
Central Bank Rates Sharply Lower



Inflation Is Going Nowhere Fast



Near-Term, U.S. Deficit Soars





We expect output to contract about 0.8% next year, with much of the weakness concentrated in Central Canada. Overall, next year's retrenchment is likely to be less than half the setback recorded in the United States.

The greater resilience of the Canadian economy reflects a number of positive fundamentals. Canadian financial institutions are rated among the strongest in the world. Canadian households have tended to build equity in their homes over the past decade, unlike their U.S. counterparts that relied on home equity withdrawals to underwrite spending. The leveraging up of higher-risk U.S. households that eventually precipitated the sub-prime mortgage crisis and credit crunch was not replicated in Canada. As a result, the drop in Canadian residential activity will be much less severe and extensive than south of the border.

The longer-term, broad-based commitment of Canadian governments to balanced budgets also will prove to be an important national strategic advantage. Previously enacted fiscal stimulus — in the form of tax cuts and spending increases — is already working to support our economy. Unlike the ad hoc, deficit-financed U.S. initiatives that have been escalating in recent months, Canadian governments have focused on longer-term, productivity-enhancing investments. Federal, provincial and municipal investment in Canada's transportation, education and health care infrastructure will offer important support to our job market and domestic demand.

That said, Canadian consumers inevitably will become even more cautious spenders in the coming months. Consumer confidence has already fallen to levels not seen since the recessions of 1981-82 and 1990-91 alongside record-low employment expectations. Canada's labour market has been much stronger than its U.S. counterpart in 2008, but employment has started to decline, with job cuts likely to accelerate over the winter as the U.S. recession deepens and the global retrenchment in commodity demand hits Canadian exporters. Even here, however, declines in the Canadian dollar and prices for gas and other commodity inputs should provide some bottom-line relief for many Canadian industries.

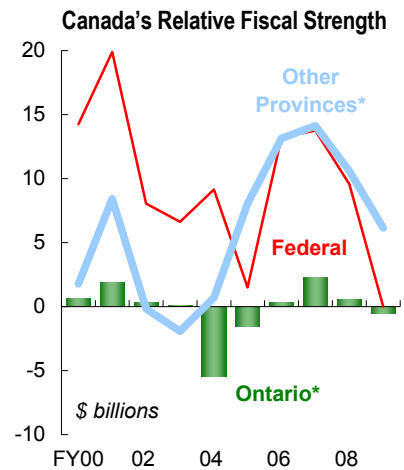
### Ontario's Economic Challenges

Carlos Gomes & Adrienne Warren

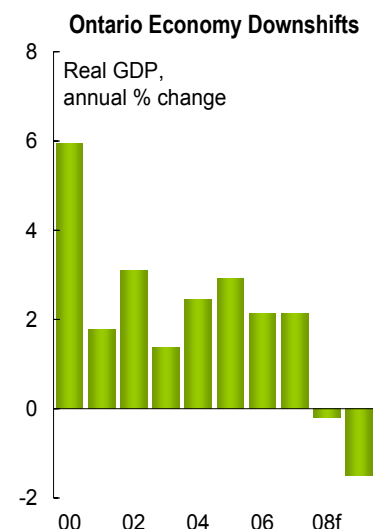
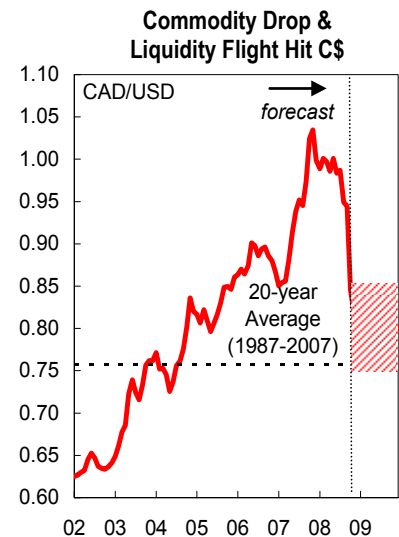
The global economic slowdown underway poses a major challenge for Ontario's struggling manufacturing sector and has clouded the outlook for a number of service industries. Economic retrenchment in North America will accelerate the process of industrial restructuring and job losses in the year ahead. Overall, we expect Ontario's output to contract by about 1½% in 2009, the weakest performance among the provinces.

Consumer spending has so far remained fairly resilient, with provincial retail sales through September up 5% from a year earlier, in line with the national trend. However, the sharp deterioration in labour market conditions in the past two months points to a much weaker consumer outlook for the new year. Provincial employment contracted in October and November, with reduced service-sector hiring no longer offsetting ongoing manufacturing job losses. The manufacturing sector has shed 80,000 workers in the past twelve months and 225,000 since the beginning of 2005.

We expect hiring to moderate across a broader range of industries in 2009, including construction, finance, business services and government. Total provincial employment is forecast to decline by about 1½% next year, or by more than 100,000 positions, lifting Ontario's unemployment rate to close to 9%



\* FY08 and FY09 provincial estimates from Budget documents.





by 2009Q4 and putting downward pressure on wage and income growth. Reduced domestic and international tourism demand and continuing net interprovincial population outflows also weigh on the retail outlook.

Residential investment also will contract in 2009. Facing a rising inventory of unsold new homes, slowing new home prices, increasing resale listings and a softening job market, provincial housing starts are expected to total around 65,000 units next year, down from an estimated 76,000 in 2008. Existing home sales have already dropped 12% year-to-date following record purchase volumes last year, with further declines in store for 2009.

Commercial construction has been solid, with several major office and hotel developments underway in the province. However, the considerable new space coming on the market in 2009 will bump up against declining office-based employment and reduced investor demand, undercutting future project development plans. Ongoing infrastructure investment in areas such as power generation and public transit will provide some offset to weakening private-sector construction activity.

Ontario's export receipts have fallen by nearly 10% in 2008, led by sharply lower auto sales. Exports have stalled or declined across most major categories, including machinery & equipment and industrial products. While the recent slide in the Canadian dollar may help to cushion earnings, this will be largely offset by weakening U.S. and global demand. Close to 84% of Ontario's foreign goods shipments are destined for the U.S. market, where new orders are falling at an accelerating pace and inventories have soared to record highs.

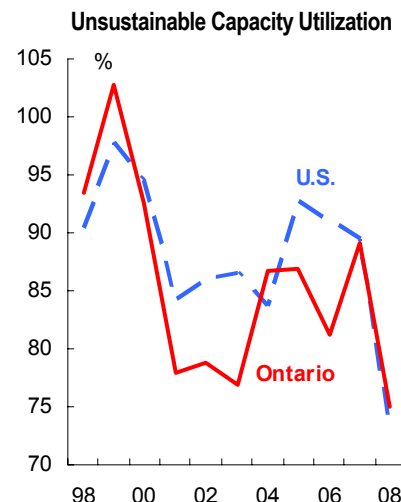
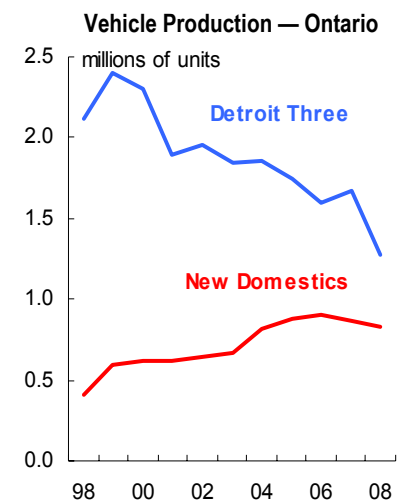
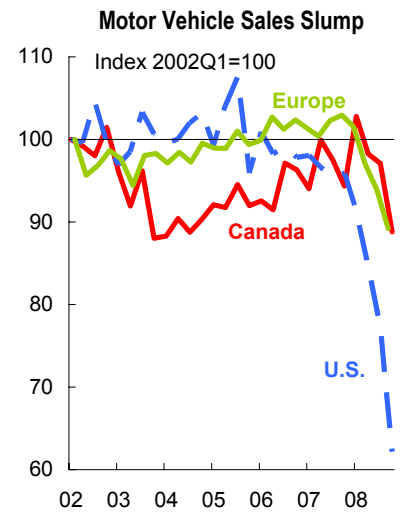
Sales of automotive products fell by more than 20% in the first nine months of 2008, reflecting a sharp contraction in U.S. vehicle purchases, particularly those produced by the Detroit Three. In November, U.S. vehicle sales plunged to a 25-year low of 10.2 million units, from an average of 14.1 million in the year through September. Faced with fewer customers and surging inventories, automakers are slashing vehicle production across North America. Fourth-quarter output is expected to be at least 17% below a year earlier.

With unsold inventories now exceeding 120 days' supply, double normal levels, the Detroit Three plan to slash their North American assemblies an additional 30% y/y in early 2009. In Ontario, these manufacturers plan to cut output 24% from a year earlier, overwhelming production gains from the new Chevy Camaro in Oshawa and the phase-in of the Toyota assembly plant in Woodstock. Foreign automakers are still scheduling higher output for their Ontario facilities, but are also experiencing sharply lower U.S. sales.

Ontario's vehicle assembly plants are the most productive in North America. However, sharp production cuts will reduce operating rates below an unsustainable 70% in 2009, indicating that additional restructuring is needed for both automakers and parts suppliers.

The province's primary metal sector also is weakening after reporting significant gains and record prices earlier this year. A sharp drop in base metal prices since mid-July has triggered several mine closures, leading to layoffs in Sudbury and other areas. Prior to these announcements, Sudbury had one of the healthiest labour markets in Ontario.

The food industry — representing 11% of provincial manufacturing activity — is an exception, as more than 70% of its shipments are consumed in Canada. Other industries with relatively solid performances to date include chemicals, petroleum & coal and aerospace, though taken together these industries make up only 15% of Ontario's manufacturing shipments and roughly 2% of economic activity.





## Adjusting Ontario's Fiscal Plan

Mary Webb

As Ontario's weakening economy undercuts government revenues, the Province will be severely challenged by escalating demands both for temporary support and longer-term funding to facilitate the restructuring of the motor vehicle sector and other key industries. The recent rapid deterioration of global and Canadian economic activity puts the Province's estimate of a \$500 million budget shortfall for FY2008-09 at considerable risk. Fiscal pressures are bound to intensify in FY2009-10.

Ontario will not be alone in grappling with red ink in FY2009-10. The federal budget shortfall could move into double digits and several other Provinces face the prospect of significant deficits. Even the resource-rich Western Provinces are likely to witness their fiscal surpluses scaled back.

For the first time in more than 2½ decades, Ontario's nominal GDP — a broad indicator of trends in the Province's own-source revenues — is forecast to edge lower in 2009 alongside declining output and weakening price trends. While corporate tax receipts will pose the largest drag, personal income tax collections will be sideswiped by realized capital losses as well as softening earnings. Recent revenue gains, such as increased land transfer tax receipts, likely will be reversed. Weakness in own-source receipts is expected to persist through FY2010-11, heightened by a legacy of loss carry-forwards.

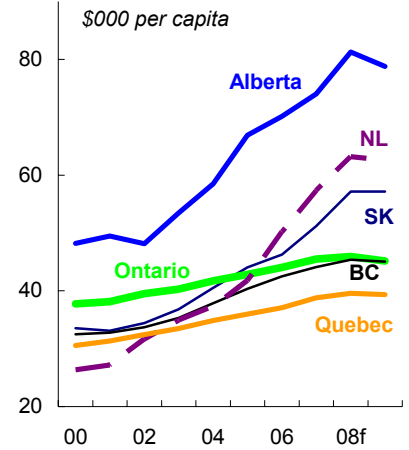
Holding the line on expenditures, given contract negotiations for much of the Province's workforce and commitments such as sequentially uploading social program costs from local governments, would necessarily entail widespread program cutbacks, a choice that could steepen the provincial economic downturn. Yet room should be made for new priorities, suggesting a fundamental reassessment of all service delivery. Even as an economic recovery emerges, the global marketplace will remain intensely competitive for financial and other services as well as manufacturing.

A rebalancing of federal-provincial transfers is needed to reduce the net drain on Ontario. As job losses mount and Ontario slips into 'have-not' status, the Province should continue to urge major reforms of several federal programs such as Employment Insurance (EI) that are biased against local recipients. Undercoverage in EI benefits will become increasingly costly for Ontario with the number of unemployed forecast to climb towards 650,000 by late 2009.

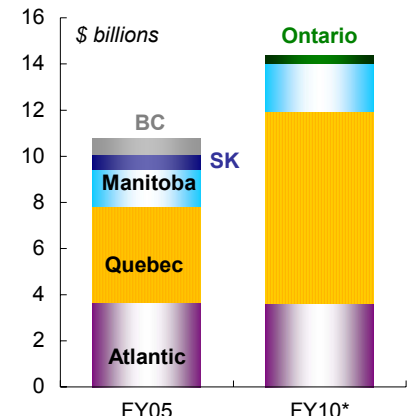
As in many other Provinces, Ontario is already committed to heightened infrastructure spending — a path that generates near-term jobs plus much-needed longer-term investment. The Windsor-Detroit border crossing is an urgent priority, as is spending to reduce traffic congestion in the Greater Toronto and Hamilton Area, which is estimated to impose economic costs of \$6 billion annually. Reducing infrastructure bottlenecks, in partnership with the private sector, represents one of several options for supporting Ontario's business sector that the Province can accommodate over the next few years. Another opportunity involves moving forward with some of the occupational pension plan reforms suggested by the Province's Commission.

For most governments, businesses and investors around the world, the unfolding retrenchment in global economic activity will exceed or rival anything experienced in modern times — both in its intensity and its duration. While fiscal deficits are the unfortunate outcome of these challenging times, the litmus tests for sound policy will be whether fiscal recovery plans are geared to improving long-term productivity and restoring balanced budgets once economic growth resumes on a durable basis.

Shifts In Provincial Nominal GDP

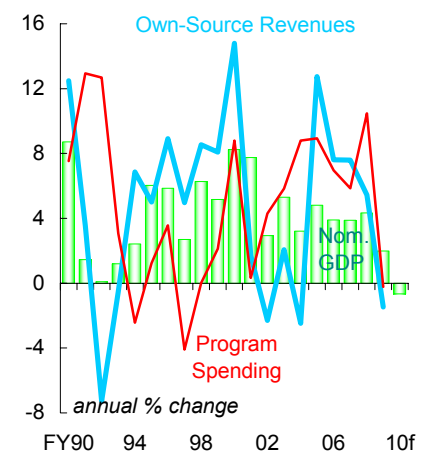


Equalization Entitlements



\*NL Accord payments excluded; for FY10 NL Equalization transfer is zero.  
Source: Finance Canada.

Ontario's Revenues Slide



Source: Ontario Finance.



Economic Performance (annual % change unless otherwise indicated)								
	2000-06	2007	2008f	2009f	2000-06	2007	2008f	2009f
		<u>Canada</u>				<u>United States</u>		
Real GDP	3.0	2.7	0.7	-0.8	2.5	2.0	1.2	-1.8
Consumer Prices	2.3	2.1	2.5	1.3	2.8	2.9	4.3	1.4
Pre-tax Profits	8.6	3.3	1.0	-12.0	10.1	-1.6	-9.0	-16.5
Federal Budget Balance (\$bn)	10.3	9.6	0.0	-8.0	-164	-162	-455	-1075
Current Account Balance (\$bn)	23.6	13.6	18.0	-20.0	-561	-731	-700	-565
Merchandise Trade Balance (\$bn)	61.3	48.0	53.0	20.0	-602	-819	-840	-695
Motor Vehicle Sales (000s)*	1,593	1,654	1,670	1,500	16.9	16.1	13.3	12.5
Motor Vehicle Production (000s)*	2,664	2,580	2,200	2,100	12.0	10.7	9.0	8.6
Housing Starts (000s)*	204	228	216	185	1.8	1.36	0.92	0.70
Employment	1.9	2.3	1.6	-0.8	0.8	1.1	-0.1	-2.0
Jobs Created (000s)*	296	380	270	-135	1.03	1.53	-0.17	-2.74
Unemployment Rate (%)	7.1	6.0	6.1	7.5	4.8	4.6	5.7	8.2
		<u>Mexico</u>				<u>Euro zone</u>		
Real GDP	2.9	3.2	1.7	-0.7	2.0	2.6	0.9	-0.9
Consumer Prices	5.1	4.0	5.1	5.6	2.2	2.1	3.2	1.7
		<u>Latin America (Excl. Mexico)</u>				<u>Asia</u>		
Real GDP	3.1	6.4	4.8	4.8	4.4	6.2	5.1	4.9
Consumer Prices	9.4	7.0	9.4	8.4	1.1	3.3	3.8	2.5

\*In the United States, millions.

Commodity Prices (US\$ annual average)				
	2000-06	2007	2008f	2009f
Pulp (tonne)	611	823	853	670
Newsprint (tonne)	555	585	695	725
Lumber (mfbm)	302	245	218	2.15
Copper (lb)	1.3	3.23	3.18	2.00
Zinc (lb)	0.60	1.47	0.86	0.55
Nickel (lb)	5.43	16.88	9.60	4.20
WTI Oil (bbl)	39.63	72.32	101	60
Nymex Natural Gas (US\$/mmbtu)	5.62	7.12	9.00	7.25
Wheat (tonne)	179	301	455	325

Financial Markets (end of period, % unless otherwise indicated)								
	2008Q1	08Q2	08Q3	08Q4f	2009Q1f	09Q2f	09Q3f	09Q4f
CANADA								
3-month T-bill	1.88	2.54	1.92	1.35	0.90	1.10	1.15	1.20
5-year Canada	2.91	3.60	3.15	2.15	2.20	2.35	2.50	2.60
10-year Canada	3.44	3.73	3.75	3.20	3.20	3.25	3.40	3.60
UNITED STATES								
3-month T-bill (Yield)	1.36	1.73	1.03	0.10	0.30	0.45	0.65	0.60
5-year Treasury	2.44	3.33	2.98	1.70	1.80	1.85	2.05	2.15
10-year Treasury	3.41	3.97	3.83	2.50	2.55	2.60	2.75	3.10
CANADIAN-US SPREADS								
3-month T-bill	0.52	0.81	0.89	1.25	0.60	0.65	0.50	0.60
5-year	0.47	0.27	0.17	0.45	0.40	0.50	0.45	0.45
10-year	0.03	-0.24	-0.08	0.70	0.65	0.65	0.65	0.50
Canadian Dollar (USD/CAD)	1.03	1.02	1.06	1.22	1.27	1.33	1.29	1.25
Canadian Dollar (CAD/USD)	0.98	0.98	0.94	0.82	0.79	0.75	0.78	0.80
Yen (USD/JPY)	100	106	106	96	88	80	81	82
Euro (EUR/USD)	1.58	1.58	1.41	1.31	1.24	1.18	1.23	1.29
Sterling (GBP/USD)	1.98	1.99	1.78	1.53	1.46	1.38	1.45	1.52
Mexican Peso (USD/MXN)	10.6	10.3	10.9	13.0	13.1	13.2	13.2	13.3



## Regional Performance

	<u>2000-06</u>	<u>2007</u>	<u>2008f</u>	<u>2009f</u>	<u>2000-06</u>	<u>2007</u>	<u>2008f</u>	<u>2009f</u>
	<u>Real GDP</u> (annual % change)				<u>Budget Balance, FY March 31*</u> (\$millions)			
<b>Canada</b>	<b>3.0</b>	<b>2.8</b>	<b>0.7</b>	<b>-0.8</b>	<b>10,378</b>	<b>13,752</b>	<b>9,597</b>	<b>0</b>
Newfoundland and Labrador	4.2	9.1	1.4	1.3	-419	154	1,377	1,266
Prince Edward Island	2.1	2.0	0.6	-0.4	-35	24	-11	-49
Nova Scotia	2.2	1.6	1.0	0.0	-9	182	419	355
New Brunswick	2.3	1.6	1.0	0.1	57	237	87	-285
Quebec	2.2	2.4	0.5	-1.0	-180	109	0	0
Ontario	2.8	2.1	-0.2	-1.5	-525	2,269	600	-500
Manitoba	2.4	3.3	1.8	0.1	n.a.	485	576	96
Saskatchewan	1.8	2.8	3.0	0.8	132	293	641	2,318
Alberta	4.3	3.3	1.7	0.1	4,348	8,510	4,581	2,003
British Columbia	3.2	3.1	1.5	0.2	294	4,079	2,886	450

\* FY09 forecasts: provincial governments.

	<u>Employment</u> (annual % change)				<u>Unemployment Rate</u> (annual average, %)			
<b>Canada</b>	<b>1.9</b>	<b>2.3</b>	<b>1.6</b>	<b>-0.8</b>	<b>7.1</b>	<b>6.0</b>	<b>6.1</b>	<b>7.5</b>
Newfoundland and Labrador	1.0	0.6	1.8	1.0	16.0	13.6	13.1	13.3
Prince Edward Island	1.9	1.0	1.6	-0.6	11.4	10.3	10.7	11.5
Nova Scotia	1.3	1.3	1.3	0.1	8.9	8.0	7.6	8.3
New Brunswick	1.3	2.1	1.0	0.0	10.0	7.5	8.5	9.2
Quebec	1.8	2.3	0.7	-1.2	8.5	7.2	7.3	8.8
Ontario	2.0	1.6	1.5	-1.5	6.5	6.4	6.4	8.2
Manitoba	1.2	1.6	1.7	0.2	4.9	4.4	4.2	5.2
Saskatchewan	0.6	2.1	1.8	1.0	5.3	4.2	4.2	4.9
Alberta	2.8	4.7	2.7	0.1	4.6	3.5	3.5	4.7
British Columbia	2.1	3.2	2.4	0.2	7.0	4.2	4.4	5.5

	<u>Housing Starts</u> (annual, thousands of units)				<u>Motor Vehicle Sales</u> (annual, thousands of units)			
<b>Canada</b>	<b>203</b>	<b>228</b>	<b>216</b>	<b>185</b>	<b>1,593</b>	<b>1,654</b>	<b>1,670</b>	<b>1,500</b>
Atlantic	12	12	12	10	110	118	129	118
Quebec	43	49	47	40	402	408	428	382
Ontario	79	68	77	65	623	593	584	515
Manitoba	4	6	6	4	44	45	47	43
Saskatchewan	3	6	7	4	38	44	48	47
Alberta	37	48	31	30	197	249	248	224
British Columbia	26	39	36	32	179	197	186	171

## Scotia Economics

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