



Economic Directions

Liftoff Achieved, But The Flight Path Will Be Turbulent

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The global recovery has achieved liftoff, led by China and a number of emerging nations. The U.S. and other developed economies also should become fully airborne in the months ahead, fuelled by unprecedented monetary and fiscal stimulus set in motion in 2009, the revival of consumer spending and the re-ignition of production as firms react to improving sales prospects. However, a legacy of high unemployment and structural weakness in key sectors such as housing and financial services points to a bumpy ride during 2010 and a relatively low-altitude global growth trajectory into the next decade.

Domestic economic conditions have been more resilient in Canada than in the U.S., in large part because of the world-class strength of our financial sector and relatively stronger household, corporate and government balance sheets. Canada experienced only about half the rate of job loss recorded south of the border during the downturn and has led the U.S. in a return to job creation. These factors have supported a rebound in consumer spending and the revival of Canada's housing market, where buyers have been taking advantage of historically low interest rates at a time when U.S. residential activity is still mired in recession.

At the same time, Canadian exporters have faced heavy headwinds, with sales receipts in the final quarter of 2009 down roughly 20% from the previous year. Commodity producers are beginning to benefit from a rebound in global markets but, with three-quarters of external sales going to the U.S., the pace of the recovery will be subdued. The rise in the loonie to 95 cents(US) — in part reflecting the recent rebound in energy and industrial resource prices — also has undercut competitiveness and squeezed earnings. More of the same could be in store if our currency moves to parity or beyond.

The pathways from recession to recovery vary significantly between Canada and the U.S., but both nations are benefitting as public infrastructure projects get underway. Canadian and U.S. motor vehicle producers are gearing up to replenish depleted dealer inventories now that sales have begun to recover. The impetus from these temporary factors will help both economies gain altitude during the first half of 2010.

While there is a risk of economic relapse as governments begin unwinding unprecedented monetary and fiscal support, the broadening of global growth across sectors and regions should sustain the recovery through 2010. In Canada and the U.S.,

| | | 2000-08 | 2009e | 2010f | 2011f |
|-----------------------------------|--|---------|-------|-------|-------|
| Real GDP (annual % change) | | | | | |
| Canada | | 2.6 | -2.5 | 3.0 | 2.8 |
| U.S. | | 2.4 | -2.4 | 3.6 | 2.6 |
| Mexico | | 2.8 | -6.8 | 4.0 | 3.1 |
| Euro zone | | 1.9 | -3.8 | 1.3 | 1.1 |
| United Kingdom | | 2.4 | -4.8 | 1.5 | 1.1 |
| Japan | | 1.4 | -5.3 | 1.0 | 0.9 |
| China | | 10.1 | 8.7 | 9.5 | 9.0 |
| India | | 7.3 | 7.5 | 7.0 | 6.5 |
| Brazil | | 3.3 | 0.5 | 5.0 | 5.0 |

| | 2000-08 | 2009e | 2010f | 2011f |
|----------------------------|---------|-------|-------|-------|
| (millions of units) | | | | |
| TOTAL CAR SALES | 49.52 | 50.91 | 52.72 | 55.44 |
| North America* | 19.01 | 12.68 | 13.88 | 14.64 |
| Canada | 1.60 | 1.46 | 1.53 | 1.57 |
| United States | 16.39 | 10.40 | 11.50 | 12.20 |
| Mexico | 1.02 | 0.82 | 0.85 | 0.87 |
| Western Europe | 14.48 | 13.62 | 12.53 | 12.84 |
| Germany | 3.28 | 3.81 | 3.24 | 3.37 |
| Eastern Europe | 2.70 | 3.01 | 3.21 | 3.41 |
| Russia | 1.52 | 1.47 | 1.60 | 1.73 |
| Asia | 10.97 | 17.68 | 18.84 | 19.99 |
| Japan | 4.47 | 3.92 | 3.96 | 4.07 |
| China | 2.56 | 7.31 | 8.77 | 10.08 |
| India | 0.83 | 1.46 | 1.60 | 1.73 |
| South America | 2.36 | 3.92 | 4.26 | 4.56 |
| Brazil | 1.46 | 2.48 | 2.72 | 2.72 |

**Includes light trucks.*

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however, this year's growth will do little more than backfill the hole created by the steep decline in activity during 2008-09. Even this modest performance will compare favourably with trends in Europe and Japan, where economic retrenchment has been much deeper and the timetable for regaining lost GDP will stretch beyond 2010.

Lingering structural impediments will keep the U.S. and other developed nations on a lower flight path in 2011. Regulatory reforms and tighter lending practices will restrict leverage and raise funding costs for higher-risk activities. In the U.S., excess capacity and refinancing challenges point to a lengthy recuperation for housing activity and non-residential construction. The U.S. consumer won't return to previous high-altitude spending patterns because the 'borrow-to-buy' impetus has given way to debt repayment and a rebuilding of savings after a 20% drop in household net worth since mid-2007. Spending enthusiasm also is being tempered by high unemployment and consumer bankruptcy rates.

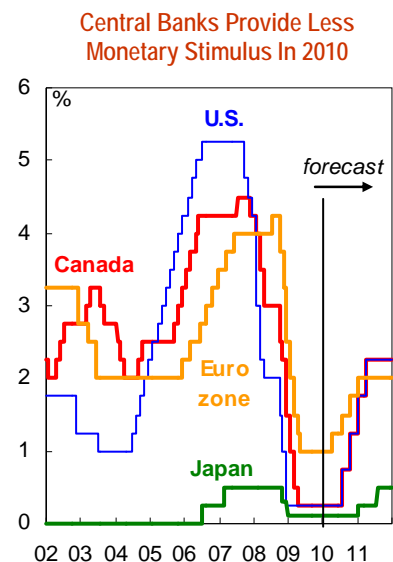
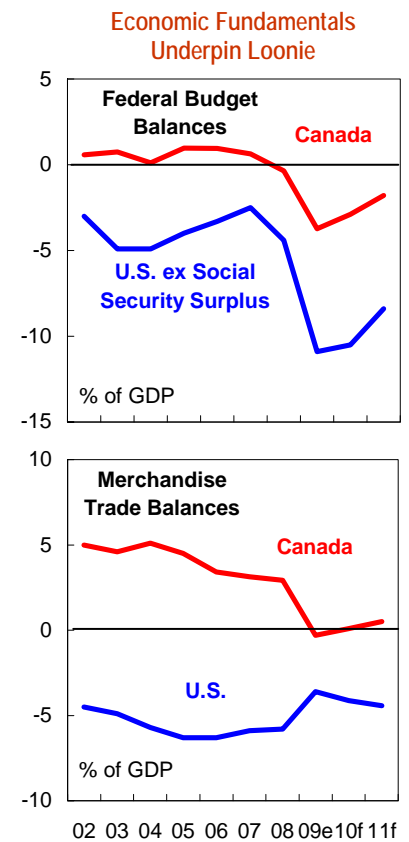
These factors will impede progress in reversing Washington's US\$1.4 trillion deficit, which is equivalent to about 10% of U.S. GDP. Although the taxpayer cost of the Troubled Asset Relief Program (TARP) has been revised lower, other expenses, including the Afghanistan campaign, are on the rise. Without additional federal aid, state and local government fiscal constraints will impose an increasing drag on the recovery. All levels of government also are confronted with the need to devote increasing resources to health care, welfare programs and environmental remediation.

With developed nations locked on a relatively low growth trajectory, China and other fast-growing emerging markets will provide a large share of global locomotion. In a year when global output shrank by over 2%, China grew by nearly 9% in 2009. Vehicle sales in China surpassed U.S. levels in 2009 and have set new records in India and Brazil. Trade flows among Asian nations are already double NAFTA levels.

Even with inflation held back by lingering excess capacity in a wide range of industries, interest rates will rise in the second half of 2010 as central banks begin easing up on the monetary accelerator, with the U.S. Federal Reserve and the Bank of Canada likely to raise rates 2 percentage points or more by mid-2011. Bond yields won't rise as much, but they are likely to move up sooner as the recovery resuscitates consumer and business borrowing at a time of unprecedented government debt issuance.

Currency markets will stay quite volatile, with the U.S. dollar vulnerable to periodic bouts of weakness as economic growth takes hold and investors diversify away from U.S. asset positions accumulated during the financial crisis. Gold purchases by central banks in Russia, China and India highlight the quest for investment diversification. Nervousness about continuing to underwrite Washington's fiscal deficit will also increase the longer it is stuck above the US\$1 trillion threshold. Adding to investor concerns will be a renewed widening of the U.S. trade deficit as a revival in consumer spending and rising energy prices push up import costs.

Despite these negatives, the U.S. dollar is not about to lose its status as the world's reserve currency. The main alternatives — the Euro, Sterling and Yen — represent regions with economic and financial challenges rivalling or exceeding those in the United States. China and other countries with large U.S. dollar foreign exchange reserves have a vested interest in tempering U.S. dollar weakness to forestall big currency-related losses on their financial assets as well as for competitive reasons. The net result — the U.S. dollar will likely exhibit wide swings but only limited depreciation through 2010-11. The countries with the greatest potential for currency





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appreciation against the greenback are the smaller, commodity-producing countries like Canada and Australia.

The Canadian Economy — Adjusting To New World Realities

Canada is on the road to recovery, but that road is not taking us back to the world that existed before the sub-prime crisis began. Canadian governments entered the recession in much better fiscal shape than our main trading partners — an important strategic advantage in dealing with the downturn. However, current deficits will be difficult to unwind, with spending cutbacks tough to implement and the revenue rebound constrained by relatively subdued economic growth. As in many other developed countries, the aging of Canada's baby boom generation will intensify upward pressures on the costs of health care and social security over the next decade.

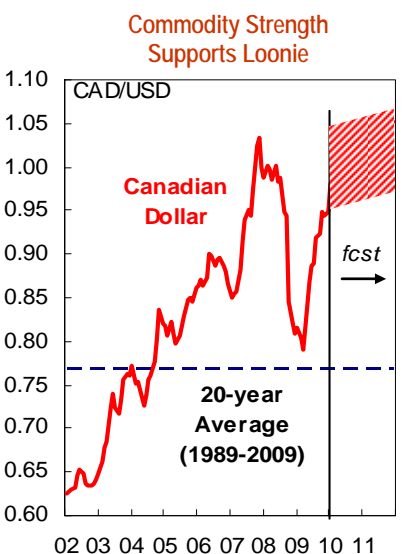
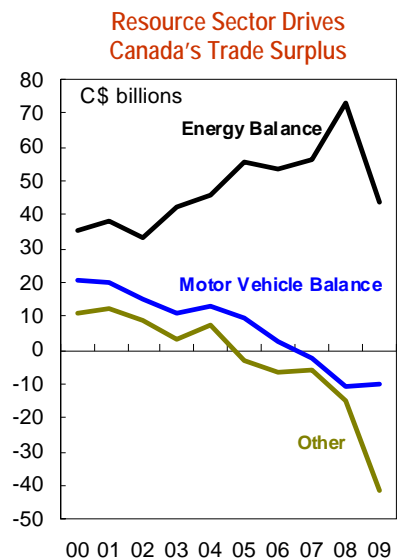
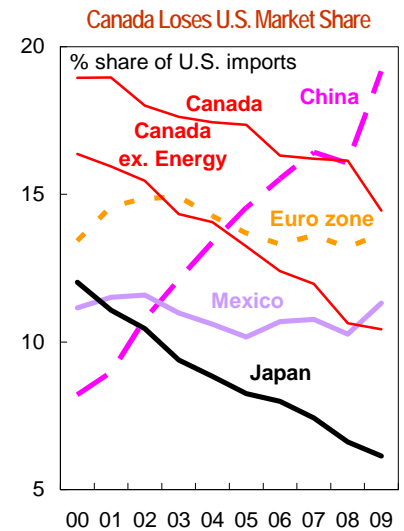
In this environment, there is little leeway to use public subsidies to insulate domestic business from the powerful forces reshaping the global economic landscape. Governments cannot afford to use the auto bailout as a template for supporting industries in crisis nor do they have the prescience to use industrial policies to pick winners and losers. A winning public sector strategy involves establishing a competitive tax environment and a world-class urban infrastructure, both of which have been given significant attention in recent federal and provincial budgets.

Education and skills training must also remain a top public priority because workforce quality is one area where Canada must be able to compete with the best. Skilled labour shortages will re-emerge as labour markets recover from the worst economic setback in a generation, limiting the potential for businesses to cut costs in the quest for a better bottom line performance. The problem will be aggravated beyond 2010 as the retirement bulge begins to hit with full force.

Canadian industries are already being forced to adjust to a rapidly changing global economic landscape. China has overtaken Canada as the top foreign supplier to the U.S. market. Excluding energy products, the euro zone has surpassed Canada in U.S.-bound sales. Canada's tourist industry has experienced a secular decline in U.S. visitors. Auto exports now account for 12% of external sales compared with 23% at the beginning of the decade. A rise in the loonie through parity — a significant possibility in 2010-11 — would exacerbate these competitive challenges.

As our businesses confront tougher realities in traditional markets, they are beginning to find a world of opportunity in new ones. Demand from China and other emerging markets has already helped push commodity exports to roughly half of Canada's foreign sales. Rising incomes in these nations will underpin rapid growth in consumer spending, providing important new opportunities for Canadian businesses. Similarly, at a time when the auto sector and other traditional manufacturing industries have been shedding jobs, new enterprises associated with environmental remediation, energy efficiency and global infrastructural development have the potential for sustained, rapid growth.

Success in these and other markets will depend on identifying high value-added, skill-based Canadian products and services that can plug into global supply chains or take advantage of unique niche market opportunities. Highly entrepreneurial small- and medium-sized businesses in these rapid-growth areas will likely be a key source of Canadian job creation over the next decade. For governments and many businesses, focussing scarce resources on familiar markets and industries, while ignoring or avoiding new and unfamiliar ones, is likely to be a losing strategy.





Economic Performance (annual % change unless otherwise indicated)

| | 2000-08 | 2009e | 2010f | 2011f | 2000-08 | 2009e | 2010f | 2011f |
|----------------------------------|---------|-------------------------------------|-------|-------|---------|----------------------|-------|-------|
| | | <u>Canada</u> | | | | <u>United States</u> | | |
| Real GDP | 2.6 | -2.5 | 3.0 | 2.8 | 2.4 | -2.4 | 3.6 | 2.6 |
| Consumer Prices | 2.3 | 0.3 | 1.7 | 2.1 | 2.9 | -0.3 | 2.6 | 2.4 |
| Pre-tax Profits | 7.7 | -33.0 | 23.0 | 12.0 | 5.3 | -5.2 | 18.0 | 10.9 |
| Federal Budget Balance (\$bn) | 8.4 | -56.0 | -46.0 | -30.0 | -197 | -1413 | -1490 | -1220 |
| Current Account Balance (\$bn) | 21.0 | -42.3 | -34.8 | -26.7 | -601 | -426 | -498 | -548 |
| Merchandise Trade Balance (\$bn) | 58.2 | -5.0 | 1.0 | 8.0 | -655 | -513 | -617 | -691 |
| Motor Vehicle Sales (000s)* | 1,605 | 1,461 | 1,525 | 1,570 | 16.4 | 10.4 | 11.5 | 12.2 |
| Motor Vehicle Production (000s)* | 2,590 | 1,425 | 1,900 | 2,050 | 11.5 | 5.6 | 7.2 | 7.5 |
| Housing Starts (000s)* | 207 | 149 | 168 | 172 | 1.65 | 0.55 | 0.73 | 1.08 |
| Employment | 1.9 | -1.6 | 1.0 | 1.6 | 0.7 | -3.7 | 0.5 | 2.3 |
| Jobs Created (000s)* | 301 | -272 | 162 | 279 | 0.89 | -5.04 | 0.65 | 3.05 |
| Unemployment Rate (%) | 6.9 | 8.3 | 8.3 | 8.1 | 5.1 | 9.2 | 9.9 | 9.2 |
| | | <u>Mexico</u> | | | | <u>Euro zone</u> | | |
| Real GDP | 2.8 | -6.8 | 4.0 | 3.1 | 1.9 | -3.8 | 1.3 | 1.1 |
| Consumer Prices | 5.1 | 3.6 | 5.3 | 4.2 | 2.2 | 0.9 | 1.3 | 1.8 |
| | | <u>Latin America (Excl. Mexico)</u> | | | | <u>Asia</u> | | |
| Real GDP | 3.8 | -0.3 | 3.6 | 3.7 | 5.2 | 1.3 | 4.9 | 4.7 |
| Consumer Prices | 8.1 | 7.1 | 7.9 | 4.7 | 1.6 | 0.0 | 1.7 | 2.0 |

*In the United States, millions.

Commodity Prices (US\$ annual average)

| | 2000-08 | 2009e | 2010f | 2011f |
|--------------------------------|---------|-------|-------|-------|
| Pulp (tonne) | 662 | 720 | 800 | 850 |
| Newsprint (tonne) | 574 | 560 | 563 | 650 |
| Lumber (mfbm) | 286 | 178 | 215 | 240 |
| Copper (lb) | 1.72 | 2.34 | 3.00 | 3.50 |
| Zinc (lb) | 0.73 | 0.75 | 0.95 | 1.05 |
| Nickel (lb) | 7.16 | 6.50 | 7.95 | 8.00 |
| WTI Oil (bbl) | 49.93 | 62 | 90 | 92 |
| Nymex Natural Gas (US\$/mmbtu) | 6.15 | 4.15 | 5.50 | 5.50 |
| Wheat (tonne) | 223 | 454 | 305 | 290 |

Financial Markets (end of period, % unless otherwise indicated)

| | 09Q4 | 10Q1f | 10Q2f | 10Q3f | 10Q4f | 11Q1f | 11Q2f | 11Q3f |
|---------------------------|-------|-------|-------|-------|-------|-------|-------|-------|
| CANADA | | | | | | | | |
| 3-month T-bill | 0.31 | 0.30 | 0.75 | 1.05 | 1.75 | 2.10 | 2.30 | 2.25 |
| 5-year Canada | 2.76 | 2.80 | 3.10 | 3.20 | 3.70 | 3.85 | 3.65 | 3.55 |
| 10-year Canada | 3.61 | 3.65 | 3.85 | 4.10 | 4.50 | 4.80 | 4.60 | 4.55 |
| UNITED STATES | | | | | | | | |
| 3-month T-bill (Yield) | 0.08 | 0.30 | 0.65 | 1.00 | 1.75 | 2.10 | 2.30 | 2.25 |
| 5-year Treasury | 2.68 | 2.70 | 3.00 | 3.10 | 3.60 | 3.75 | 3.60 | 3.55 |
| 10-year Treasury | 3.84 | 3.85 | 4.15 | 4.40 | 4.80 | 5.10 | 4.90 | 4.85 |
| CANADIAN-US SPREADS | | | | | | | | |
| 3-month T-bill | 0.23 | 0.00 | 0.10 | 0.05 | 0.00 | 0.00 | 0.00 | 0.00 |
| 5-year | 0.08 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.05 | 0.00 |
| 10-year | -0.23 | -0.20 | -0.30 | -0.30 | -0.30 | -0.30 | -0.30 | -0.30 |
| Canadian Dollar (USD/CAD) | 1.05 | 1.02 | 1.00 | 0.98 | 0.97 | 0.97 | 0.96 | 0.95 |
| Canadian Dollar (CAD/USD) | 0.95 | 0.98 | 1.00 | 1.02 | 1.03 | 1.03 | 1.04 | 1.05 |
| Yen (USD/JPY) | 93 | 90 | 88 | 87 | 87 | 89 | 90 | 91 |
| Euro (EUR/USD) | 1.43 | 1.42 | 1.45 | 1.47 | 1.44 | 1.43 | 1.43 | 1.41 |
| Sterling (GBP/USD) | 1.62 | 1.63 | 1.64 | 1.65 | 1.64 | 1.63 | 1.63 | 1.62 |
| Mexican Peso (USD/MXN) | 13.1 | 13.4 | 13.5 | 13.8 | 13.9 | 13.9 | 13.8 | 13.8 |



| Provincial | 2000-08 | 2009e | 2010f | 2011f | 2000-08 | 2009e | 2010f | 2011f |
|-------------------------|--------------------------------------|-------|-------|-------|---------------------------------------------------|--------|---------|---------|
| | Real GDP (annual % change) | | | | Budget Balance, FY March 31* (Millions) | | | |
| Canada | 2.6 | -2.5 | 3.0 | 2.8 | 10,666 | -5,755 | -56,000 | -46,000 |
| Newfoundland & Labrador | 4.6 | -3.9 | 3.1 | 3.0 | -149 | 2,350 | -443 | n.a. |
| Prince Edward Island | 1.9 | -1.2 | 2.2 | 2.1 | -25 | -33 | -85 | n.a. |
| Nova Scotia | 2.0 | -1.4 | 2.3 | 2.2 | 60 | 20 | -525 | n.a. |
| New Brunswick | 2.0 | -1.3 | 2.1 | 2.3 | 79 | -192 | -754 | -749 |
| Quebec | 2.1 | -1.7 | 2.7 | 2.4 | -128 | 0 | -4,695 | n.a. |
| Ontario | 2.4 | -3.4 | 3.1 | 2.5 | -90 | -6,409 | -24,716 | n.a. |
| Manitoba | 2.4 | -0.8 | 2.8 | 2.6 | n.a. | 470 | -592 | n.a. |
| Saskatchewan | 2.3 | -1.5 | 3.0 | 3.3 | 207 | 2,389 | 425 | n.a. |
| Alberta | 3.5 | -2.6 | 3.2 | 3.5 | 4,837 | 0 | 0 | n.a. |
| British Columbia | 2.9 | -2.5 | 3.3 | 3.1 | 660 | 78 | -2,775 | n.a. |

* FY09-FY11 prov. balances: government estimates.

| | | | | | | | | |
|---------------------------|----------------------------------------|------|-----|-----|-------------------------------------------------|------|------|------|
| | Employment (annual % change) | | | | Unemployment Rate (annual average, %) | | | |
| Canada | 1.9 | -1.6 | 1.0 | 1.6 | 6.9 | 8.3 | 8.3 | 8.1 |
| Newfoundland and Labrador | 1.0 | -2.5 | 0.9 | 1.6 | 15.4 | 15.5 | 15.5 | 15.1 |
| Prince Edward Island | 1.7 | -1.1 | 0.6 | 1.1 | 11.3 | 12.0 | 12.2 | 12.0 |
| Nova Scotia | 1.3 | -0.1 | 0.8 | 1.1 | 8.7 | 9.2 | 9.2 | 8.9 |
| New Brunswick | 1.3 | 0.1 | 0.7 | 1.2 | 9.6 | 8.9 | 8.9 | 8.7 |
| Quebec | 1.7 | -1.0 | 0.8 | 1.4 | 8.3 | 8.5 | 8.6 | 8.5 |
| Ontario | 1.9 | -2.4 | 1.0 | 1.5 | 6.5 | 9.0 | 9.0 | 8.8 |
| Manitoba | 1.3 | 0.0 | 1.0 | 1.4 | 4.8 | 5.2 | 5.1 | 5.0 |
| Saskatchewan | 0.9 | 1.5 | 1.1 | 1.8 | 5.1 | 4.8 | 4.7 | 4.5 |
| Alberta | 3.0 | -1.3 | 1.3 | 2.0 | 4.3 | 6.6 | 6.5 | 6.3 |
| British Columbia | 2.2 | -2.4 | 1.2 | 1.6 | 6.4 | 7.6 | 7.8 | 7.6 |

| | | | | | | | | |
|------------------|-------------------------------------------------------|-----|-----|-----|------------------------------------------------------------|-------|-------|-------|
| | Housing Starts (annual, thousands of units) | | | | Motor Vehicle Sales (annual, thousands of units) | | | |
| Canada | 207 | 149 | 168 | 172 | 1,605 | 1,461 | 1,525 | 1,570 |
| Atlantic | 12 | 11 | 11 | 11 | 113 | 115 | 119 | 121 |
| Quebec | 44 | 43 | 43 | 43 | 405 | 390 | 402 | 416 |
| Ontario | 77 | 50 | 58 | 60 | 615 | 535 | 557 | 572 |
| Manitoba | 4 | 4 | 5 | 5 | 44 | 43 | 45 | 46 |
| Saskatchewan | 4 | 4 | 5 | 5 | 40 | 44 | 46 | 48 |
| Alberta | 37 | 20 | 24 | 25 | 207 | 184 | 198 | 205 |
| British Columbia | 29 | 16 | 22 | 23 | 181 | 150 | 158 | 162 |