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# ECONOMIC OVERVIEW

## INTERNATIONAL OVERVIEW

The global economy decelerated in 2005 as a result of higher energy prices and a series of natural disasters. Although the outlook remains favourable for 2006, with GDP growth remaining above 4%, the continued rise of energy prices or a spike in interest rates could potentially soften global demand. The global economy remains heavily reliant on the strength of China and the United States as the drivers of economic expansion.

The gap continues to widen between “aging” and “emerging” economies in terms of economic growth potential. The long-term growth potential of aging economies, in particular Western Europe and Japan, continues to slow due to demographics. Essentially, the population in these markets is aging and, as a result, so too is the labour force. This, in turn, is giving rise to higher pension and health costs and greater financial burden. Structural problems continue to exist in both France and Germany. The need for significant labour market reforms remains at the forefront of political objectives, however, this overhaul is easier said than done. In Japan, not only is the population aging, it is also shrinking in size, which has significant labour market ramifications for the long term.

On the flip side, the emerging economies—in particular Brazil, China, India, and Russia – have seen improved economic policies and performance. Having a typically younger and growing population, these emerging economies have a greater overall growth potential for the long term.

## UNITED STATES

The US economy continues to lead the G7 industrialized countries. Despite rising energy costs and devastating hurricanes, the US economy continued to show strength in 2005. The immediate negative impact felt by Katrina, Rita, and Wilma on the US economy will be negated by the boost in investment and spending in the clean-up and rebuilding phase in 2006.

A flexible, young labour market and consistent population growth will help to preserve economic growth in the short-term. However, a large deficit makes the sustainability of consistent economic growth in the US questionable. US consumers continue to spend despite record debt loads and rising interest rates. However, the side effects of 2005’s hurricanes and rising energy prices have begun to dampen consumer sentiment.

Rising corporate profits have led to increased investment in business machinery and equipment. This investment is critical for corporate America to remain competitive on the global scene and for continued economic expansion.

A cooling in the housing market is inevitable and will ultimately be a catalyst for a slowdown in the US economy in 2006. Although some

markets continue to fair better than others, overall office vacancies are at their lowest point in over three years, placing upward pressure on rental rates. Pre-leasing requirements by lenders will keep new supply disciplined. Job creation remains solid boding well for continued strength in overall demand for office space. The national industrial market continues to tighten highlighting the solid fundamentals at play in the industrial market.

## LATIN AMERICA

Latin America had one of its best years in decades thanks in part to China’s appetite for exports and strong commodity prices. Sustainable economic recovery appears to be underway, which should continue through 2006. Presidential elections are scheduled in 2006 for Mexico, Brazil, Chile, and Peru that may fuel some market volatility over the year for these countries.

Similar to the US, Mexico also felt the effects of the hurricane season, as Wilma tore through the tourist areas of Cancun and the Yucatan Peninsula and Stan tore through southern Mexico and Guatemala. However, Mexico’s economy is expected to expand by 3.6% in 2006. The economic performance of Mexico remains highly linked to the US as 80.0% of Mexican exports are US bound. The export sector remained buoyant with robust US demand and rising energy prices. However, any slowdown in US demand in 2006 will be an impediment to growth for Mexico.

Monetary policy reform by the Central Bank of Brazil led to a decrease in inflation during 2005, but there is still a long way to go. Solid export growth and a reduction in external debt have increased Brazil’s ability to repay its existing debts prompting S&P to upgrade Brazil’s credit rating. Domestic demand is showing renewed strength, however, the current interest rate now sits at 19.0%.

Argentina recorded a third consecutive year of growth coming out of the 1999-2002 recession. High inflation continues to be a problem for Argentina and, as a result, higher interest rates are expected to prevail although this may prove to be ineffective over the near term.

Soaring energy prices have bolstered Venezuela’s economy and the political conflict over President Hugo Chavez’s government has subsided, leading to increased stability in the country. However, the President’s move from a free market economy to what he calls “21st century socialism” will keep Venezuela as a troubled spot in the global market. The economy will maintain a relatively high growth rate over the coming months with domestic demand strong and unemployment declining.



## EUROPE

The European economy will see a gradual pickup in 2006. Although recovery still remains fragile it does appear to be broad based across all sectors, which bodes well for increased stability going forward.

The German economy continues to be troubled by sub-par growth, high unemployment, and low consumer confidence. The September 2005 election proved inconclusive – a “grand coalition” formed after three weeks of negotiations, which will likely further delay much needed labour market reform. Business confidence rose to a five year high in 2005, however, domestic consumption remains weak.

In France, the government’s failure to adequately address employment concerns continues to weigh heavily as witnessed by unrest and rioting in the streets in the fall of 2005. This unrest could dampen the accelerated growth forecast for 2006.

The UK economy is on track to post its lowest growth in over a decade. A record high consumer debt burden created by rapidly rising house prices will impact market stability and confidence into 2006.

Russia has recorded strong economic growth since the collapse of communism and has made significant progress since 2000 when President Putin took office. As one of the world’s largest oil producers, Russia is currently enjoying a windfall from high energy prices. However, the ruble has been appreciating and this is having a negative impact on Russian manufacturers.

## ASIA PACIFIC

Despite rising energy costs, the economies of the Asia Pacific have remained resilient. China will continue to be one of the world’s fastest growing economies. Exports, investment, and consumer spending are the key drivers of China’s growth. Although economic growth was slightly slower in 2005, 2006 will be another solid year with growth at close to 9.0%. Despite being a huge net importer of oil, China has not felt the pressures of rapidly increasing energy prices that many other world markets have felt. Consumer spending and domestic demand has been accelerating consistently, and this trend will need to continue in order to offset eventual softer export demand from North America and Europe.

Japan’s economy continues to rebound moderately, after years of recession, as a result of increased business and consumer spending. Full time employment and wages have been increasing while corporate profits have been supporting increased business investment. However, consumer spending will be limited in 2006 as income tax rates increase.

Australia’s economy will come into a more stable growth path for 2006, driven by business investment and export growth. Consumer spending has moderated as interest rates moved upward in 2005 cooling the housing boom. Inflation may edge upwards due to rising energy prices but remain within the target range.

## NATIONAL OVERVIEW

For Canada, 2005 was a tale of two economies – a booming West and a moderate East. High energy and commodity prices are dividing the country in terms of economic outlook. Alberta, British Columbia, and Saskatchewan are reaping the benefits while Ontario and Quebec continue to struggle with the compounding effects of the rising dollar and energy prices on their energy intensive manufacturing base. Energy prices are forecast to ease somewhat in the coming months. This should take some of the pressure off the rising Canadian dollar, which has increased roughly 29.0% since 2002, reaching a 13-year high in 2005. Over the near term it is domestic demand, not export growth, which will carry the Canadian economy as net exports have been eroded by the rapid rise in the dollar.

Canada’s unemployment rate is the lowest it has been in 30 years at 6.4%. Over 250,000 jobs were created in the economy in 2005, the majority of which were full-time positions. Skilled labour shortages, particularly in the west, are putting significant pressure on output. Rumours are increasing regarding bonuses for interviewing, signing bonuses, and other inducements as employers compete to attract labour.

Corporate profits rose throughout 2005, with high energy prices translating into record profits for the energy sector. Conditions are ripe for business investment with the stronger dollar giving businesses increased purchasing power, reducing the costs of imported machinery and resulting in increased investment in capital equipment and machinery.

Consumers continued to spend in 2005, driven by low financing rates. As a result, total consumer debt is on the rise, which could prove problematic to overleveraged consumers in a rising interest rate environment. The good news is that, although interest rates are forecast to continue to rise throughout 2006, the increase is not expected to be sharp enough to have a measurable impact on consumers over the near term.

The Bank of Canada is continuing to unwind its monetary stimulus in an effort to keep inflation balanced, essentially stabilizing economic growth. Overnight rates are forecast to rise to 4.0% by the fall of 2006 before stabilizing at this level. This will likely have a cooling effect on the booming residential market, which has continued to reach new highs over the past few years, both from a construction start and resale value standpoint. Resale activity posted a record high in 2005 and house prices reached their highest point in 16 years. Housing price increases, combined with modest increases in mortgage rates, will slow the pace of new home construction in 2006 although still remaining above the 200,000 level.

The outlook for 2006 remains positive with the economy forecast to expand by 2.9%. The gap between East and West will remain intact. Energy prices are expected to pull back slightly, however, as world demand for oil remains robust, the Canadian economy will continue to benefit as a whole.

## PROVINCIAL OVERVIEW

### BRITISH COLUMBIA

The BC economy performed better than expected in 2005. BC is experiencing robust expansion and this growth appears to have staying power. Strong employment growth continues, which should support healthy consumer demand – the strongest performance recorded in the last 10 years. The economy is forecast to post solid growth in 2006 at 3.5%, fuelled by resurgence in the natural resources sector and the ramp-up to the 2010 Olympic Games. Olympic momentum will see the start of construction on the \$1.7 billion rail line connecting Richmond, Vancouver, and the Airport; Richmond speed skating oval; and winter sports centre at the University of British Columbia.

Employment growth, coupled with improved consumer confidence, will continue to fuel spending and retail sales in the province. The red-hot housing market will cool off over the near term as new starts weaken. Demand levels are still strong and, although starts are forecast to cool in 2006, they will remain at relatively high levels.

The Provincial Government raised the expected surplus for 2005/06 to \$1.3 billion. In addition the province has also cut the corporate tax rate by 1.5%.

### ALBERTA

By no coincidence, Alberta was the growth leader in 2005 – driven by development and investment in the oil sands, which is expected to exceed \$80 billion over the next five years. The prosperity is forecast to continue during 2006, although Alberta is expected to be runner-up to Newfoundland & Labrador in economic growth, before regaining the throne once again in 2007.

Strong wage gains and job creation have allowed for a very healthy provincial economy, however, the strains of this rapid economic growth are becoming increasingly evident. Alberta now posts the lowest unemployment rate in the country. Both skilled and unskilled labour shortages and infrastructure shortfalls are key concerns causing capacity and production constraints.

Despite anticipated softening of the housing market in 2006, housing starts remain at record levels. Low interest rates, strong in-migration levels, and solid job growth will continue to fuel demand for housing in the province.

The Alberta government is operating with a surplus in excess of \$2.8 billion and the \$400 “resource rebate” cheque going out to each resident will further fuel consumer spending. Retail sales continue to benefit from higher employment and increased disposable income.

### SASKATCHEWAN

Saskatchewan also benefited from strong resource sector output with increased potash and uranium production. Mining activity is expected to remain solid in 2006. The weakened agriculture sector is expected to see a rebound in 2006 in terms of quality of crop output and, with the US border re-opened to live cattle under 30 months of age, prairie farmers are feeling better about their economic prospects.

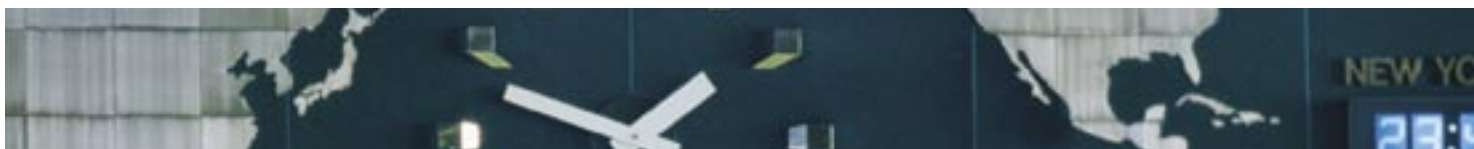
The housing market is beginning to experience some softening, which is expected to carry over through 2006. Retail sales remain solid, reflecting strong job creation and increased consumer confidence.

### MANITOBA

Relatively bright prospects are expected for the Manitoba economy in 2006. Despite the difficult agricultural season posted in 2005, as a result of heavy rains, Manitoba recorded stable growth. The agricultural sector is expected to improve in 2006 with a rebound in crop yield and the end of anti-dumping duties imposed on the pork industry.

Construction activity is forecast to increase further in 2006. Non-residential construction is booming with large investments in both the energy and non-energy related sectors.

Manitoba is experiencing strong population growth which should continue to fuel demand in the housing sector. For the third consecutive year, housing starts have exceeded 4,000 units and the forecast for 2006 calls for a continuation of this trend. Unemployment in the province is the strongest it has been since 1976, at 4.2%, and second only to Alberta.



#### ONTARIO

The export sector in Ontario is continuing to struggle, impacted by both increased energy prices and the appreciating Canadian dollar. The potential slowdown in US demand forecast for 2006 will have an impact on overall economic growth. The automotive industry, a key driver of the province, will continue to face a series of challenges over the near term. Announcements made by General Motors and Ford of plant closures, shift reductions and layoffs will have a trickle down effect on parts suppliers and automotive related manufacturers, dampening the manufacturing outlook. In general, manufacturing payrolls trended downwards in 2005 and this trend is expected to continue during 2006.

Consumer spending remains the saving grace, with strong domestic demand and low interest rates keeping consumers active in 2006. In addition, rising corporate profits have put businesses in a spending mode, taking advantage of more inexpensive imports and low financing costs to upgrade investment in equipment and machinery.

The housing sector is expected to begin easing to more sustainable levels, with housing starts expected to decline to 75,000 units in 2006.

#### QUEBEC

Similar to Ontario, Quebec's manufacturing sector continues to struggle from the compounding effects of higher energy prices, the appreciating Canadian dollar, as well as international competition for output. The struggling export sector did receive a boost in 2005, however, with increased demand for aerospace products. In addition, the non-residential construction sector will get a boost from the development of new hydro-electric facilities by Hydro Quebec, further increasing the province's generating capacity.

Job creation in the province is expected to remain sluggish over the near term, which will have an impact on domestic demand. Retail sales improved in 2005 but are expected to soften in 2006 as consumer confidence loses some of its momentum.

Weak economic conditions and the erosion of pent-up demand resulted in a decline in housing starts. This trend will carry throughout 2006.

Export growth will help the overall bottom line, but it is forecast to remain sluggish, which will dampen personal income growth. The promise of personal income tax cuts aimed at low-income families is not likely to happen in the spring 2006 budget as planned.

#### NEWFOUNDLAND & LABRADOR

Newfoundland & Labrador are expected to jump to the head of the pack in 2006 with strong economic growth fuelled by the Voisey's Bay and White Rose mega projects. Unfortunately this will only be temporary as output peaks in 2006 and then declines from there.

Employment has traditionally been a problem for the province and although the unemployment rate saw improvement in 2005, it averages 15.0%, the highest in the country. A declining population base and sluggish employment growth will ease demand for housing in the province. Housing starts declined in 2005 and are expected to soften further in 2006.

#### PRINCE EDWARD ISLAND

The PEI economy is experiencing fairly soft yet steady growth, with GDP growth forecast at 2.1% in 2006. Potato farmers have had ongoing issues with poor crops due to weather, soft pricing, and decreased consumer demand given the "low carb" craze. In 2005, farmers reduced their crops by 10,000 acres, which resulted in reduced output yet stronger prices.

Job creation has also remained steady, with a number of large infrastructure projects on the go. However, employment growth will contract slightly when these projects end. In the meantime, current employment levels will boost consumer confidence and result in decent retail sales activity over the near term. In 2004 housing starts reached their highest level since 1988. Housing starts cooled in 2005 and are expected to decrease further in 2006.

#### NOVA SCOTIA

Economic growth in 2005 was softer than expected as a result of labour market sluggishness. Despite this, housing starts increased to roughly 4,800 units in 2005, up slightly from 2004. Housing starts are forecast to decline modestly in 2006.

2005 marked the fourth consecutive year of decline for the natural gas sector in Nova Scotia. Despite strong energy market prices, natural gas production in the province declined 7.0% in 2005, as all interest focused on the Alberta oil sands and the clean up and repairs of the Gulf region's drilling operations.

The Nova Scotia economy is forecast to expand modestly in 2006, posting 2.8% GDP growth. It is expected that this growth will be driven by some non-residential construction projects, including the expansion of the Halifax Airport, harbour cleanup, and the possible construction of a liquefied natural gas project set to get underway in 2006.

#### NEW BRUNSWICK

New Brunswick manufacturers are facing similar challenges as those in Ontario and Quebec. Employment growth is expected to be lackluster, yet despite this, consumer demand remains healthy. Housing starts are on a downward trend through 2006 but will remain solid in historical terms.

Numerous capital projects are on the horizon for New Brunswick, supporting a modest growth forecast for 2006. Construction of a \$750 million liquid natural gas facility in Saint John, refurbishment of the Point Lepreau nuclear plant, as well as plans for a \$70 million gypsum wallboard plant at the former Saint John shipyard, and a \$30 million biomass co-generation facility will bolster New Brunswick's growth and improve the employment outlook.

