First Canadian Place in the heart of Toronto's financial district at the corner of King and Bay. BMO Financial Group Chief Economist Douglas Porter looks at 10 economic and fiscal fundamentals going into this election year. Photo Matthew Liteplo. www.liteplo.com

Ten Reasons Why We Can Still Appreciate This Economy

Douglas Porter

At the end of a year that closed with an oil-price shock and 10 months ahead of a scheduled federal election, BMO Financial Group Chief Economist Douglas Porter looks at the fundamentals of the Canadian economy which, while not "blemish-free" may be living through what we'll one day call "the good old days."

Canadian financial markets ended 2014 in a suddenly sour mood, dimming the outlook for economic prospects in the new year. In particular, there has been intense concern over the impact of lower oil prices in Canada, even with the recent run of surprisingly upbeat domestic economic data. While sagging commodity prices will no doubt drag on the resource rich areas of the country, there are still a number of improving trends at work as well. For example, there have been steady gains in employment over the last six months, and the jobless rate is close to its lowest level in more than six years.

Still, even the Bank of Canada often highlights the downside risks for the economic outlook and any areas of underperformance, while anxiously awaiting a return to "normal". Yet, by many metrics, Canada has long since returned to normal. In fact, we may look back on current conditions as the good old days. Consider the many positives at play on the economic landscape.

Rising home ownership rates, strong home prices, robust global equity markets, and good old-fashioned savings have driven household net worth to a record high as a share of disposable income (i.e. after netting out the record levels of debt). Put another way, households have $5.40 in assets for every $1 of debt.

1 **THE JOB MARKET:** This is probably the most oft-cited component of the economy's underperformance, with many pointing to persistent underlying slack (e.g. part-time workers who want to work full time). But the simple fact is that over the last three months, our unemployment rate was the lowest in the past 40 years (6.6 per cent average), aside from a three-year slice of Nirvana from late-2005 to late-2008 (at the tail end of the commodity boom). While some highlight the fact that the employment-to-population ratio is still close to its post-recession low, this is largely due to demographics (the early baby boomers retiring). The employment rate for 15-64 year olds has been steadily grinding higher since the 2009 low, and was only above current levels during the 2006-08 spell.

2 **CONSUMER SPENDING:** While the US consumer is finally getting back to normal, the Canadian consumer barely blinked this cycle. Auto sales are easily on track to shatter 2013's record high in 2014, headed for 1.88 million units. That's roughly 13 per cent above the already-frothy pace in the six years prior to the recession.

3 **HOUSING:** Another area responding in spades to persistently low borrowing costs is the unstoppable housing market. While the big gains in 2014 were largely confined to the big three cities (Toronto, Vancouver, and Calgary), that doesn't detract from the broader picture that housing surprised—yet again—to the upside in 2014. National home sales and values were both headed for roughly 5 per cent gains, with average prices hitting yet new record highs in recent months.

4 **HOUSEHOLD BALANCE SHEETS:** The nasty stepsister of record home prices is record household debt, which many have highlighted for years. What doesn't get nearly the attention is the rapid rise on the other side of the ledger—assets. Rising home ownership rates, strong home prices, robust global equity markets, and good old-fashioned savings have driven household net worth to a record high as a share of disposable income (i.e. after netting out the record levels of debt). Put another way, households have $5.40 in assets for every $1 of debt.

5 **GOVERNMENT FINANCES:** While the US is celebrating the fact that Washington's budget deficit has dropped below $500 billion, Ottawa is on course to balance the books, even with the increasing pinch of lower oil prices and the cost of the recent tax relief for parents. Of course, many provinces still face important medium-term challenges, but overall, net government debt is slowly receding again. And, at around 50 per cent of GDP, it is much lower than most of the rest of the OECD.

6 **INFLATION:** Even as much of the industrialized world grapples with inflation that's too low for comfort, Canada's rate is still very close to its 2 per cent target. In fact, Canadian inflation rose to 2.4 per cent in October, among the highest in the industrialized world. While relatively high inflation would seem no cause for celebration, most major economies would welcome a small dose of slightly faster price increases at this stage of the cycle. In any event, the steep slide in oil prices is likely to pull Canadian CPI lower, although the good news for consumers will be blunted by the falling Canadian dollar. Concern over "lowflation" is very much a rich world problem, as inflation in developing economies is approaching its highest level in nearly two decades (aside from the oil-related spike in 2008).

7 **TRADE SURPLUS:** After dipping into the red for four of the past five years, Canada's merchandise trade was headed for a small surplus in 2014. True, the black ink is a fraction of the pre-recession level, and the steep oil price drop threatens the gains, but an improving U.S. economy and a falling Canadian dollar point to non-energy export growth in 2015. Even with the oil price dive, we look for the current account deficit (the broadest measure of trade) to stay around a manageable 2.5 per cent of GDP in 2015.

8 **FINANCIAL CONDITIONS:** Even with the late-year swoon in stocks, Canada's overall financial conditions are close to the strongest in 15 years (topped only by the 2009 bounce out of the recession). Contributing to solid financial conditions are low interest rates, tight corporate bond spreads, a lower loonie, strong home prices, and easier lending conditions. According to Bank of Canada surveys, businesses find that credit conditions in the past two quarters have been the easiest in 13 years of data.

9 **PRODUCTIVITY:** Often cited as the weak spot of Canada's long-term economic performance, there is even good news on this front. In the past year, business sector labour productivity has vaulted 3.3 per cent, the fastest pace since the heady days of the tech boom in 2000.

10 **LABOUR PEACE:** Workers have not only been much more productive recently, but they have also been much less likely to strike. While this is not a particularly new development, it seems to be becoming even more obvious—the number of days lost to work stoppages over the past four years has been the lowest in Canada since the mid-1960s.

The list of good news stories is not to suggest that the Canadian economy is blemish-free; there are still many areas where improvement is needed. For instance, more full-time jobs, firmer wage growth, a narrower current account gap, and stronger provincial finances would all be more than welcome. As well, sagging oil and metals prices are a drag on the Canadian dollar and will weigh heavily on growth in 2015. But, it is to suggest that this cycle is a lot more mature than many give it credit for (including, it seems, the Bank of Canada), and we shouldn't overlook the many economic positives that are already staring us straight in the face.

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OUTLOOK FOR 2015: We look for Canada's economy to grow 2.2 percent in the coming year, as growth benefits from stronger US activity and a weaker Canadian dollar, but low oil prices will weigh. The Bank of Canada will likely not pull the trigger on rate hikes until the late fall (or even possibly longer if oil prices keep softening), at least a few months after the Federal Reserve finally begins to tighten its policy. This delayed reaction by the Bank of Canada, along with the pull from low oil prices, points to further weakness in the Canadian dollar. We look for the currency to dip below 85 cents (US) in 2015, after averaging just slightly above 90 cents in 2014.

On the fiscal side, the federal government was easily on track to balance the books in the coming fiscal year, despite a heavy dose of tax cuts and benefit increases announced in late 2014. However, the deep slide in oil prices does put that outlook in some danger. The deficit for this fiscal year remains pegged at $2.9 billion (0.1 per cent of GDP), as a better-than-expected handoff from FY13/14 offsets the initial impact of lower oil prices and new policy measures.

Importantly, the $3 billion fiscal cushion remains fully in place throughout the forecast horizon, so we could still see balanced books by the time FY14/15 is officially wrapped up. Ottawa is targeting a $1.9 billion surplus in FY15/16 and an average of $5.4 billion per year in the three subsequent years, quite a bit smaller than expected in the spring, but that includes the impact of the policy moves announced in October 2014 and still leaves some margin for error from lower crude prices. Net debt is expected to gradually fall as a share of GDP, dipping below 25 per cent by FY19/20—the downward trajectory is a tad less steep now with smaller surpluses ahead. P

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