Economic Outlook for 2011

Canadian Manufacturers & Exporters
Jayson Myers

Manufacturing and exporting outpaced the Canadian economy in 2010 and will do so again in 2011. In fact, sustaining Canada's economic recovery depends on a continuing rebound in manufacturing production as well as on the strength of our exports of resources, manufactured goods, and services to markets around the world.

The Canadian economy is expected to have grown 2.8% in 2010, notching its strongest performance in five years. (The economy grew by only 0.5% in 2008 and then contracted sharply by 2.5% in 2009.) After discounting for price changes, real economic output (gross domestic product) surpassed its pre-recessionary peak in August 2010.

Manufacturing production grew by an estimated 5.7% in 2010 – marking the first year of growth for Canada's manufacturing sector in five years. (Real production levels fell by 1.3% in 2006, 2.3% in 2007, 6.1% in 2008, and 11.3% in 2009.) At the end of 2010, manufacturing output was approximately 91% of its pre-recessionary level, but only 84% of its peak level recorded in the first quarter of 2006.

The sales value of goods manufactured in Canada increased more rapidly than production levels in 2010. Total manufacturing sales are expected to exceed $540 billion in 2010, a 10% increase from 2009. Canada's clothing, wood products, petroleum products, non-metallic mineral products, primary metals, machinery, electronics, transportation equipment, and specialized technology sectors all experienced higher-than-average sales growth over the past year.

Exports helped drive both the Canadian economy and Canada's manufacturing sector in 2010. Export volumes rose by an estimated 6.8%, with exports of goods up by 7.5% and services up by 1.8%. Exports of automotive products (+55%) and industrial goods and materials (+12%) led the way in 2010.

With price changes also being taken into account, the value of Canada's merchandise export sales is expected to have increased by around 9% over the past year. Exports to all major markets expanded in 2010, with sales to the United States growing by 4.5%, exports to Japan and to Europe rising by 10% and 15% respectively, and exports to other countries jumping by more than 30%.

Economic growth will not be as strong in 2011. Real GDP is forecast to rise by 1.5% to 2.0% over the course of the coming year.

Weaker economic performance in 2011 reflects the slower growth that can be expected in consumer demand, housing construction, and government spending within Canada – three of the leading sources of demand that helped propel the Canadian economy out of recession last year.

- Consumer spending grew by 3.5% on a year-over-year basis during the first three quarters of 2010. But, Canadian consumers have been taking advantage of low interest rates. They have been borrowing to spend more. Household consumer and mortgage debt is now at record levels, topping 150% of personal disposable income. This makes consumer demand highly sensitive to changes in interest rates or property values. A 50 basis point across the board increase in interest charges would, for instance, cost every Canadian an average of $220. The cumulative impact on all Canadians would be to cut real consumer spending growth by 0.9% and GDP growth by 0.6%. Even if interest rates do not go up significantly over the course of the coming year, consumers are likely to start saving more and paying down their debt. As a result, real consumer spending can be expected to increase by only 2.0% in 2011.

- Residential construction activity grew by 12.8% on a year-over-year basis during the first three quarters of 2010. With mortgage debt at record levels and re-sales activity slowing down, housing construction is not expected to be as strong in 2011. It is forecast to contract by 3.5 over the course of the coming year. This forecast assumes that there will be no sharp increase in interest rates which would certainly cut demand for new homes further and send property prices falling.

- Current spending by all levels of government rose 3.8% and public infrastructure investment grew by 11.2% % on a year-over-year basis during the first three quarters of 2010. Government spending helped to seed Canada's economic recovery over the past two years, but the price has been record deficits. After 12 years of government surpluses, Canada's public sector deficit rose to 4.4% of GDP in 2009 and 3.9% for the first three quarters of 2010. All governments will be focusing on deficit reduction in 2011. Real government spending can be expected to increase, but by only 1.5% in 2011, allowing for a 0.5 percentage point cut in Canada's public sector deficit to GDP ratio.

Two sources of demand are likely to be more important in sustaining economic growth in 2011:

1. Business investment in machinery and equipment. Business spending on machinery and equipment rose 10.7% on a year-over-year basis during the first three quarters of 2010. With business profits on the rise and tax rates on investment slated to fall further throughout the course of the coming year, capital spending on machinery and equipment can be expected to grow even more rapidly, by an estimated 16%, in 2011.

2. Exports of goods and services. Export volumes grew by 6.4% on a year-over-year basis during the first three quarters of 2010. With economic recovery strengthening in Canada's major export market, the United States, and stronger demand in markets around the world for Canadian resources and manufactured products, export production should grow by at least 10% in 2011.

Business investment in new machinery and equipment and stronger demand for Canadian exports will be good news for Canada's manufacturing sector. Production levels are expected to rise by 5.0% in 2011 and manufacturing sales are forecast to grow by 7.5%.

This forecast is based on the assumptions that:

- Consumer price inflation will continue to average 2% or less in 2011;
- Interest rates will increase on average by less than 50 basis points throughout the year;
- Canada's dollar continues to hover near parity with the US dollar;
- Canada's unemployment rate edges downwards slightly to 7.8% by the end of next year.

There are a number of risks to this forecast:

- A surge in the Canadian dollar past parity would cut into export sales and reduce the business profits driving capital investment activity – Risk factor = 40%;
- An increase in interest rates of more than 50 basis points would significantly erode consumer spending and new housing construction – Risk factor = 30%;
- The appearance of significantly more stringent trade restrictions in international markets would impede export growth – Risk factor = 25%; and,
- Further financial turmoil caused by debt defaults would increase long-term interest rates and jeopardize international economic growth, weakening both domestic demand in Canada and international demand for Canadian exports – Risk Factor = 15%.

There are also a number of things that would make a positive contribution to Canada's economic growth forecast for the coming year:

- A stronger than expected economic recovery in the United States that would increase demand for Canadian exports and alleviate upward pressures on the Canadian dollar;
- Faster than expected growth in Canadian oil sands and other energy developments which would boost both business investment and demand for manufactured goods within Canada; and,
- Further improvements in the tax treatment of business investments in productive assets such as manufacturing technologies, research and development activity, and workplace training. Policy changes like extending the two-year write-off for investments in manufacturing and processing machinery and equipment, making the Scientific Research and Experimental Development Tax Credit fully refundable, and introducing a workplace training tax credit that could be applied against higher payroll taxes would all make a positive difference in encouraging businesses to invest more in innovation and productivity enhancement, which would in turn help to boost personal income and overall economic growth.