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Every month, Current Economics reviews the research produced by top international economists from the world’s leading firms, selecting a sample of the best available for publication. Coverage includes analysis of topical issues, the economic outlook for a selection of countries and, periodically, the outlook for exchange rates and interest rates.

As a benchmark for comparison with the views of individual researchers, a table of the latest consensus forecasts for growth, inflation and current account balances is presented on the back page.
Summaries

Asia: The Impact of Oil
Rob Subbaraman, Michael Kurtz and Simon Flint, Nomura, Hong Kong
Page 3
Rob Subbaraman, Michael Kurtz and Simon Flint analyse the impact of rising oil prices across Asian economies. Demand for the commodity eased in the fourth quarter of 2011 and the authors attribute the recent price spike to a combination of high global liquidity, supply disruptions and geopolitical concerns in the Middle East. Observing that there are six main channels through which oil prices can affect economies to varying degrees depending on the level of exposure, the authors outline three different oil price scenarios for 2012. They examine empirical models used by the IMF and the Asian Development Bank, and use this to supplement their own study of the likely impact of high oil prices on Asian economies under the three different scenarios.

Euro Zone: 2012 Deficit Targets Can Barely Be Reached
Christoph Weil, Commerzbank, Frankfurt
Page 7
While their economies struggle to regain traction as they sink deeper into recession, finance ministers in the Euro area have set some ambitious fiscal consolidation targets for 2012. Noting that nine countries now expect higher deficit ratios than those strictly authorized by the Stability and Growth Pact, Christoph Weil considers their ability to meet deficit targets to be highly dependent upon economic growth fundamentals and creative accounting (including transfers of money from governmental sectors to the public coffers). With these factors in mind, he concludes that, unfortunately, many euro countries will fail to meet these targets this year.

Canada: Manufacturing Rebound Belies Competitive Challenges
Dina Cover, TD Economics, Toronto
Page 10
Having enjoyed a cyclical rebound from the 2009 recession, Canadian manufacturing data seemingly indicate a relatively healthy economy. However, Dina Cover observes that despite some modest revival in output levels, job growth in the sector has not enjoyed expansions of the same magnitude. Moreover, previous competitive advantages like lower labour costs and a weaker C$ have now been completely eroded. With a view that manufacturers must increase their competitiveness by containing costs and investing in advanced practices and technologies, the author projects that near-term output and employment, although improving, will remain below the peaks seen over the past decade.

Is Greece Ring-Fenced?
Stephane Deo, UBS, London
Page 14
With immediate concerns of a Greek default having been delayed somewhat by Euro zone negotiations, Stephane Deo describes in detail the country’s next bailout package. He also examines whether Greek contagion has been ring-fenced to a certain extent. Despite the latest developments, Deo feels that the outlook remains downbeat and is doubtful that targets will be met since Greece’s current fiscal situation is highly unsustainable. He believes that while the country remains fundamentally unbalanced, and with the net external position about 100% of GDP in the negative, a further restructuring of debt looks unavoidable.

Growth Continues, But Latvia is Not Immune to Euro Zone Problems
Lija Strašuna, Swedbank, Latvia
Page 18
The Latvian economy enjoyed the strongest rate of growth in the European Union in the fourth quarter of 2011, surpassing neighbouring countries such as Lithuania and Estonia. In the context of continuing difficulties in the Euro area, Lija Strašuna warns that Latvia is by no means immune to external headwinds, and that growth in the country is indeed slowing. On a positive note, though, confidence is still robust and exports remained relatively healthy last year, but Strašuna concludes that further developments will depend upon the future strength of exports, and observes that long-standing issues such as income inequality and slow job creation, along with labour market and demographic problems will not be resolved even if strong growth continues.

Brazil – Single-Digit Rates to Stay
Bret Rosen and Italo Lombardi, Standard Chartered, New York
Page 21
A surprise 75 basis point cut to the SELIC rate on March 7 has resulted in a single-digit policy rate of 9.75%. Bret Rosen and Italo Lombardi believe the current monetary stance will stoke inflation and expect price rises to head above the centre of the central bank’s target band (2.5-6.5%). They go on to examine Brazil’s sub-par performance in 2011, especially the weak outlook of the industrial sector. The sluggish pace of economic activity has led Rosen and Lombardi to take the view that the authorities are willing to tolerate stronger inflation to enable it to deliver higher growth. Consequently, they believe the SELIC rate will fall further in the coming months, and the central bank is likely to adopt macro-prudential measures should inflation strengthen rather than reverse its previous rate cuts.

Where Might the Australian Dollar Base?
Andrew Salter and Tim Riddell, ANZ Research, Sydney
Page 25
Andrew Salter and Tim Riddell discuss where the Australian dollar is likely to base in the event of a moderate slowdown in growth, which is expected over the coming year. They identify two possible scenarios; one which projects a modest slowdown that would see the Australian currency likely trading above US$1.035, and a second which mimics the deep slowdown seen in 2011 and would cause it to base somewhat below this level. However, the authors do not see the latter as their central scenario and are confident of the A$ settling at around US$1.10 in the medium-term.
Asia: The Impact of Oil
Rob Subbaraman, Michael Kurtz and Simon Flint, Nomura, Hong Kong

Macro models likely overstate the economic impact of rising oil prices, but we are also cognizant that the impact varies across Asia, with India, Korea, Thailand and the Philippines most exposed.

The rise in the price of Brent crude took a breather in the last week of February, stabilising at about US$124/bbl, but up nearly 15% from US$108/bbl at the end of last year. This pales in comparison to the 364% surge over the prior five years to the peak of US$144/bbl in July 2008, but the recent run-up is not insignificant and the current level is already relatively high. We show the different channels through which Asia’s economies are affected by rising oil prices and how the size of the impact varies considerably across countries. We conduct a “what if” exercise, assuming three different oil price scenarios in 2012 – the good, the bad and the ugly – and estimate the impact on GDP growth, inflation, fiscal and current account positions, and policy rates for 10 countries.

Demand vs Supply
The economic impact of rising oil prices depends crucially on whether it is being driven by a positive global demand shock, or by a negative global supply shock. The initial catalyst of the 2004-2008 run-up in oil prices seemed to be driven more by robust global demand, whereas the oil price shocks in the 1970s were caused more by negative supply shocks involving geopolitical disruptions of Middle Eastern oil supply and the US dollar’s decline following President Nixon’s 1971 breaking of gold convertibility. A supply-driven oil price surge is likely to result in a bigger growth-inflation trade-off, creating more of a dilemma for central banks.

We do not see compelling evidence that the recent rise in oil prices is being driven by a positive global demand shock. Granted, the US economy has gained some vigor, but the euro area is in recession and growth in Emerging Market economies – the largest incremental consumers of oil – is cooling. Estimates of world oil supply and demand by the International Energy Agency (IEA) show a significant easing in excess demand in the fourth quarter of 2011 (Figure 1, below) and the IEA expects world oil demand to fall this quarter and the next, in line with our forecast of global GDP growth slowing from 3.7% in 2011 to 3.2% in 2012. High levels of global liquidity, combined with supply disruptions and geopolitical concerns in the Middle East, may have more to do with the recent rise in oil prices. Net long non-commercial oil futures contracts have surged recently (Figure 2, below).

Asia’s High Exposure
At the global level, higher oil prices result in a transfer of income from oil-importing to exporting countries through a shift in the terms of trade. Asia ex-Japan is not completely without oil reserves, but with its massive industrialization and growing consumer affluence, it only produces in aggregate enough to cover one-third of its needs. Asia ex-Japan’s annual net imports of crude and refined petroleum increased from US$234bn in 2009 to US$329bn in 2010, and to a record US$447bn in 2011. Asia’s net oil imports closely track the spot price of oil (Figure 3, page 4). From a linear regression, we estimate that a US$10/bbl rise in Brent crude adds US$3.5bn to Asia’s monthly net oil import bill. If oil prices keep rising, Asia is more exposed than most other regions.

Net imports of crude and refined petroleum as a share of GDP is a handy metric to assess which economies in Asia are most exposed to rising oil prices, although there are some caveats in using this measure. It does not directly take into account how much oil is produced domestically,
how efficient the economies are in consuming energy, or the direct impact on growth or inflation. Nonetheless, with this in mind, the results are revealing (Figure 4, above). Thailand was the most exposed last year, with net oil imports comprising 8.9% of its GDP, followed by Korea (6.4%). Malaysia was Asia’s only large net exporter of oil.

Six Channels

Rising oil prices can impact economies through six main channels:

• **Narrower trade surpluses.** Higher oil prices worsen the terms of trade (i.e., increase the price of imports relative to the price of exports) and tend to have a quick and direct effect on the net oil import bill, thereby narrowing Asia’s trade surpluses, *ceteris paribus*. India is particularly vulnerable as it is the only big economy already running a current account deficit.

• **Worse fiscal positions.** Some governments provide fuel subsidies to shield the private sector from higher retail fuel prices. Fuel subsidies amid rising global oil prices not only reduce the incentive for firms and households to ration energy demand but also worsen the fiscal position. The surge in oil prices in 2004-2008 led to some reduction in fuel subsidies across Asia, but they still remain fairly large, notably in India, Indonesia, Malaysia, Thailand and China. India seems the most vulnerable given its large fiscal deficit.

• **Profit margin squeeze.** The rise in the cost of energy inputs raises the cost of production, putting pressure on profit margins, which can delay new capital expenditure.

• **Higher inflation.** Depending on the extent that companies seek to restore their profit margins, they will pass on a portion of the higher costs to consumers, stoking headline CPI inflation. Also, because of agriculture becoming more energy intensive and the increased use of biofuels, oil and food prices have become more closely correlated. This is particularly relevant in Asia given the very high combined weight of food and energy-related items in CPI baskets, at over 50% in India, Indonesia and the Philippines.

• **Hurts domestic consumption.** The higher cost of retail fuel and other energy-related consumer items eats into household real income, hurting domestic consumption.

• **Second-round effects.** The greater the marginal propensity of oil producers to save their oil revenues, the larger the negative impact on global demand. According to the IEA, oil exporters spend on average about 75% of their extra oil revenues on imports within three years, so on a net basis, higher oil prices hurt global demand. For Asia’s very open economies, this can have second-round effects through weaker exports. Another second-round effect is if workers seek to offset the erosion in real income by demanding higher wages. This can trigger a wage-price spiral, lifting core inflation and inflation expectations, ultimately leading to stubbornly high inflation, as was the case in the 1970s. How sensitive Asian central banks are to an oil price-driven rise in headline CPI inflation – and hence how impelled they are to respond with tighter policies – varies depending on factors such as the weight of commodities in the CPI basket and the central bank’s reputation as an anti-inflation fighter. In our view, the central banks of India, Indonesia, Thailand and the Philippines are the most sensitive to an oil price-driven rise in headline inflation; those in Malaysia, Singapore and Taiwan have medium sensitivity; while those in China, Hong Kong and Korea have low sensitivity.

Macro-Econometric Models...

Back in December 2000, the International Monetary Fund (IMF) conducted a detailed study on the impact of higher oil prices on the global economy, employing its MULTIMOD macro-econometric model to simulate the impact of a sustained US$10/bbl rise in oil prices on GDP growth, inflation and the current account. The study showed a negative impact on Asian GDP growth of 0.8 percentage points (pp), which, unsurprisingly, is larger than that on
most other emerging markets and industrialized countries, especially after allowing for second-round effects (Figure 5, above).

In mid-2004, the Asian Development Bank (ADB) conducted a similar exercise on the Asian economies, but using the Oxford Economic Forecasting model (Figure 6, below). The aggregate results are fairly similar to those of the IMF study, but there are notable differences among countries, highlighting the sensitivity of macro-econometric models to their design and working assumptions. Interestingly, the ADB study also considered the impact of the US$10/bbl rise in oil price lasting for seven quarters (rather than just four), with the results clearly showing that the more persistent the rise in oil prices, the more damaging the economic effect.

... Do Have Their Limitations

One limitation of empirical models is that they give the average elasticity based on the sample size of historical data, but in practice the impact of higher oil prices on economic variables is likely to vary over time. The end of cheap oil and the fact that the average monthly Brent crude oil price has stayed above US$100/bbl for the past 13 months, versus just six months in 2008, have most likely increased the incentive for countries to substitute via alternative energy sources and using energy more efficiently. In Asia there is a lot of scope for the latter (Figure 7, page 6). For these two reasons it could be argued that the IMF and ADB models tend to overstate the impact of oil price rises on Asian economies. On the other hand, with the global economy now more fragile than during the 2004–2008 run-up in oil prices, evidence of a positive demand shock on oil today is less compelling. Moreover, some Asian governments now have relatively worse fiscal positions, making it more difficult to raise fuel subsidies to shield the private sector.

Macro models also typically struggle to capture the idiosyncrasies of individual countries. Among others, these include 1) varying levels of government fuel subsidies and other policy responses; 2) the initial fundamental conditions; and 3) changes in external and fiscal shocks. The latter is particularly relevant in a region with a high dependence on trade and capital inflows.
tions of economies, for example, India, with already high inflation as well as a current account deficit and a large fiscal deficit, looks particularly vulnerable at this juncture (Figure 8, above); and 3) movements in exchange rates, for instance, again in India, because of the weaker rupee oil prices in local-currency terms are already near a new record high.

The Good, the Bad and the Ugly Scenarios
Supplementing the results of the empirical models with the expertise of our country specialists, we have conducted our own “what if” exercise to assess the impact on GDP growth, CPI inflation, current account balances, fiscal positions and policy interest rates, under three different scenarios for the average quarterly path of oil prices this year:

• **Good (our base case).** The price of Brent averages US$120/bbl in quarter one, but then supply-side concerns/financial speculation fades and the oil price falls to US$115/bbl in quarter two, US$105/bbl in quarter three and US$100/bbl in quarter four, giving a 2012 average of US$110/bbl.

• **Bad.** The oil price averages US$125/bbl in each of the four quarters of this year.

• **Ugly.** The oil price averages US$125/bbl in quarter one, but supply-side concerns/financial speculation intensify causing the oil price to spike to an average of US$150/bbl in quarter two, during which demand destruction starts to kick in. The oil price then falls to US$140/bbl in quarter three and US$125/bbl in quarter four, giving a 2012 average of US$135/bbl.

From a big-picture perspective, we make five points.

1. Asia ex-Japan’s 2012 total **GDP growth** slows from 6.6% in the good scenario (our base case) to 6.4% in the bad scenario and to 6.1% in the ugly scenario. We thus believe that the big macro-econometric models are overstating the impact of a higher oil price. That said, we do see a wide spectrum: in the ugly scenario, GDP growth is hit hard, falling by about one percentage point (pp) in India, Korea, Thailand and the Philippines, while China, Malaysia and Singapore are least-affected.

2. Asia ex-Japan’s 2012 **CPI inflation** rises from 4.5% in the good scenario to 5.2% in the ugly scenario, led by big inflation surges of 1.8pp in the Philippines and Thailand.

3. Asia ex-Japan’s 2012 total **current account surplus** narrows from 1.4% of GDP in the good scenario to 0.6% in the ugly scenario, but with some big divergences across the region. In the ugly scenario, India’s current account deficit increases to 4.0% of GDP, while Malaysia’s current account surplus swells to 11.5% of GDP.

4. Asia ex-Japan’s 2012 aggregate **fiscal deficit** widens from 2.1% of GDP in the good scenario to 2.8% in the ugly scenario, led by 0.9% GDP increases in India, Korea and the Philippines. Of these three, India would have the largest fiscal deficit, of 5.9% of GDP.

5. The **monetary policy** outlook is very different in the good and ugly scenarios. In the good scenario, nearly all Asian central banks cut rates further this year, by 25-100bp from current levels. By contrast, in the ugly scenario we would expect policy rates to be kept on hold for the rest of this year in India, Korea and Taiwan; and hiked in Malaysia (25bp), Thailand (50bp), the Philippines (75bp) and Indonesia (100bp). In the ugly scenario we would expect only China to cut rates (25bp).

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**Note:** Originally published on March 1 2012 as part of “Asia Special Report: What if Oil Prices Keep Rising?” by Nomura Global Economics and Strategy. The article provides further in-depth country analysis with regards to the effects of rising oil prices.
Euro Zone: 2012 Deficit Targets Can Barely Be Reached

Christoph Weil, Commerzbank, Frankfurt

Euro zone finance ministers have set some highly ambitious consolidation targets for 2012. In this note, we show that for many countries these targets will likely be too ambitious. Some will probably be forced to lower their goals, as Spain and the Netherlands have already done. While this bodes well for economic growth in the short-term and should therefore be welcomed by many investors, it might add further fuel to the sovereign debt crisis in the medium term. In the second half of the year, the crisis should be back on the front burner.

The Deficit Targets for 2012
Finance ministers have promised to considerably trim back their deficits this year compared to 2011 (Chart 1, below). Spain and Italy, which are particularly closely monitored by investors, aim to slash their deficits by more than 2% of GDP. This does not apply to Portugal which managed to reduce the deficit in 2011 to the level originally envisaged for 2012. However, this was entirely due to the fact that the pension funds of the four largest banks were shifted to the Portuguese government, resulting in one-off revenues equivalent to around 3% of GDP. In 2012, these revenues will have to be replaced by more permanent measures.

However, finance ministers will be unlikely to receive much praise for their consolidation efforts. After all, nine countries, including the entire periphery with the exception of Italy, are targeting a higher deficit ratio than is allowed under the Stability and Growth Pact (Chart 2, below). In fact, the Greek and Irish targets are more than twice the permitted deficit ceiling of 3% of GDP. In all of these countries, debt levels relative to GDP looks set to rise further.

How Realistic Are the Targets?
The lesson we learnt in 2011 is that whether the targets are achieved largely depends on three factors:

1. Economic growth
Whether the deficit targets are met hinges above all on the economy. In nearly all cases, those countries in which GDP growth came in below the assumptions in the 2011 stability programmes also failed to meet their deficit targets – in some instances by a wide margin (Chart 3, page 8). In Greece, for instance, GDP contracted by 6½%, which was two percentage points lower than originally assumed, while the deficit target was missed by more than one percent of GDP. This phenomenon is not confined to the periphery. In the Netherlands, weaker growth was also accompanied by a higher deficit. In Germany, however, which has not embarked on consolidation efforts, the public deficit was lower than expected due to solid growth. Apparently, politicians either lack the will or the ability to plug new holes in their national budgets by launching additional consolidation measures.

This year, higher unemployment will again tear new holes in national budgets (Chart 4, page 8). To meet their 2012 deficit targets, Spain, Italy and the Netherlands, for instance, would have to implement additional austerity measures equivalent to roughly 1% of GDP. In Portugal and Greece, cuts would have to amount to almost 2% of GDP. When drawing up their budgets, finance ministers have not always taken due account of the growth shortfall (Chart 5, page 9). For Italy, in particular, we see a high risk that the economy will contract at a faster-than-assumed rate. The official forecast for Ireland, which projects a 1.3% expansion, also seems overly optimistic. Even the Irish central bank only expects growth of 0.5%. With regards to

Chart 1: 2012 Deficit Reduction Targets
Change in public deficit versus 2011 outcome as % of GDP

Chart 2: Still a Far Cry From Balanced Budgets
2012 deficit targets in % of GDP

Source: National stability programmes, Commerzbank Research

Source: National stability programmes, EU Commision, Commerzbank Research
Euro Zone: 2012 Deficit Targets Can Barely Be Reached

Economic growth in Spain, on the other hand, we are far more optimistic than the government.

(2) Creative accounting
Apart from growth, the starting basis also plays a role in meeting the deficit targets. Without the one-off measures, the Portuguese deficit would have come in at 7.5% of GDP in 2011, well above the 6% target, even though the economy did not contract as sharply as feared. Exchanging future liabilities for a one-off payment constitutes a burden for the future. The government now has to pay pensions to former bank employees and in order to raise this additional expenditure, the government has to cut spending in other areas. In Spain, the new government is pursuing the opposite approach. It obviously made use of its discretionary powers to report an exaggerated deficit for 2011. Against this backdrop, consolidation requirements in Spain will likely be more moderate than the figures suggest.

(3) The control of finance ministers over the overall budget
The direct influence which finance ministers can exert on the budget is limited to central government finances, whereas they have far less control over expenditure by regional authorities, the social security systems and public companies. In Spain, for example, excessive deficits in the regions were a key reason why the aggregate deficit missed its 2011 target by a wide margin. The Greek and Portuguese governments are unable to get a grip on the deficits run up by state owned enterprises. In Spain, the majority of regions have promised to limit their 2012 deficit to 1.5% of GDP. And in Portugal and Greece, central government is seeking to impose stronger curbs on the
finances of public companies. We doubt, however, that they will manage to fully get a tight grip on these problems in 2012.

If Necessary, Deficit Targets Are Watered Down
In the first consolidation round, governments relied primarily on boosting revenues. Spending cuts were, for the most part, limited to public investment. In the second round, social benefits and public sector employment need to be reduced. However, politicians are far more reluctant to implement these measures, as they are likely to meet with strong resistance from interested parties. Moreover, with unemployment on the rise, governments are becoming less willing to put a further damper on economic growth by venturing ahead with additional consolidation measures (Chart 6, above). It was indeed quite remarkable that Spain succeeded in raising its 2012 deficit target from 4.4% to 5.8% of GDP without causing any outcry. There was no public criticism from other euro countries nor indeed from the European Union Commission. With this in mind, we have come to the conclusion that the European Community is unlikely to call for additional deficit reduction efforts in 2012, should a country fail to meet its deficit target. The Netherlands has already abandoned plans to trim the deficit to 2.2% of GDP in 2012, as envisaged in the stability programme. Meanwhile, it is even doubtful whether the new 4.1% target will be achieved. Moreover, Portugal is also seeking to raise its 2012 deficit target.

Conclusion: Many Countries Are Likely to Miss Their Deficit Targets
We expect that many euro countries will again fail to meet their deficit targets this year. This holds above all for the peripheral countries, as they will likely struggle with the impact of recession in 2012. As we have done over the past two years, we will continue to provide a timely evaluation of their consolidation progress. However, there is a risk that non-peripheral countries may also miss their deficit targets. This is particularly true for the Netherlands. Even the Central Planning Bureau, the government’s institute for fiscal policy analysis, expects that the deficit in 2012 will come in at 4.5% of GDP.

Initially, the majority of investors will probably not react with disappointment if governments fail to plug new budget holes by implementing additional austerity measures, or if they indeed raise official deficit targets. In the short-term, this bodes well for economic growth. In the medium term, however, this strategy is hazardous. As a result, debt will continue to rise, and sooner or later investor scepticism over the ability of certain countries to service their debt in the long term will resurface. In our view, peripheral bond spreads are thus likely to rise markedly, in particular in the second half of the year. The European Central Bank might then be compelled to provide further long-term repo operations, despite any reservations which it may have about such a course of action.
Canada: Manufacturing Rebound Belies Competitive Challenges
Dina Cover, TD Economics, Toronto

Canadians have been bombarded by seemingly mixed headlines on the state of Canada’s manufacturing sector in recent months. For example, “Manufacturing output is rebounding strongly from recession”, “Employment in manufacturing declines again”, “Major plant closes its doors and plans relocation to the United States”. This report attempts to clear some of the air by drawing on the most recent figures. In a nutshell, the story is one of a sector enjoying a cyclical recovery from the recession, but continuing to face significant longer-term challenges.

Chart 1 (below) tells the story of how the manufacturing sector shrank from its peak in 2000 to the lows of the recession in 2009 – both in terms of output and employment. Prior to the recession, the declines were brought on by the fact that many of the conditions that were supporting the sector in the 1990s and the early part of the decade – including a loonie worth 60-70 US cents, low energy prices and relatively lower labour costs – have since turned into challenges. As well, the thickening of the US border over the past 10 years has created additional headwinds for manufacturers who export their products Stateside.

Not surprisingly, the recession exacerbated the downtrend in both output and employment. However, consistent with some of the better news that has emerged recently, output has been clawing its way back with a rebound of 13% since mid-2009. As shown in Chart 2 (right), industries that have been driving the manufacturing recovery are machinery and transportation equipment. Machinery is the only manufacturing industry where output has surpassed pre-recession levels – largely due to a 135% surge in construction, mining and oil and gas field machinery output. A resurgence of the auto sector underpinned the robust growth seen in transportation, as motor vehicle manufacturing has rebounded by over 90%. As of December, manufacturing output was sitting about 4% below pre-recession levels and its share of total output was 12.9% – down from a peak of 18% in 2000.

Unfortunately, employment has not fared so well, with only a third of the jobs that were lost during the recession recouped. As a share of total employment, manufacturing jobs currently account for fewer than 10%, compared to a peak of over 16% in 2000. Historically, there has been a very tight relationship between changes in output and employment in the manufacturing sector. But since the start of 2010, that relationship has been almost non-existent. Part of the disconnect can be linked to cautious hiring by businesses during the recovery, since the US economy –

Chart 2: Real GDP By Manufacturing Sector
June 2009 - December 2011

<table>
<thead>
<tr>
<th>Industry</th>
<th>% chg</th>
</tr>
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<tbody>
<tr>
<td>Machinery</td>
<td>2.2</td>
</tr>
<tr>
<td>Transportation Equip</td>
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<tr>
<td>Plastics/Rubber</td>
<td>2.7</td>
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<tr>
<td>Primary/Fabricated Metal</td>
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<td>Wood</td>
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<tr>
<td>Non-metallic Mineral</td>
<td>7.4</td>
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<tr>
<td>Electrical Equip/Appliance/Component</td>
<td>7.5</td>
</tr>
<tr>
<td>Textile/Leather/Cloth</td>
<td>4.1</td>
</tr>
<tr>
<td>Furniture/Related</td>
<td>3.9</td>
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<tr>
<td>Computer/Electronic</td>
<td>3.7</td>
</tr>
<tr>
<td>Chemical</td>
<td>3.5</td>
</tr>
<tr>
<td>Beverage/Tobacco</td>
<td>3.3</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>3.2</td>
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<tr>
<td>Food</td>
<td>3.1</td>
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<td>Paper</td>
<td>3.0</td>
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<td>Petroleum/Coal</td>
<td>2.9</td>
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<td>Printing/Related Activities</td>
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Source: Haver Analytics
where a large chunk of Canadian-manufactured goods are destined – has been improving at only a tepid pace and the global economic environment has become overshadowed with an enormous amount of uncertainty. Instead of growing their workforce, manufacturers have been using overtime to boost output, which can only last so long given the added cost.

One recent bright spot within the sector is food manufacturing – due in part to the fact that the country is rich in agricultural resources. Food processing was the only manufacturing sector to grow during the recession – likely the reason it hasn’t been a key contributor to the recovery. And with 230,000 jobs, it employs more workers than any other manufacturing industry. What's more, despite a flat performance during the recovery on the output side, roughly a fifth of all manufacturing jobs gained over the past two years were in the food processing industry.

Needless to say, central Canada has suffered the largest declines in manufacturing activity over the past decade. While Ontario has enjoyed a stronger rebound following the recession (relative to a flat performance in Quebec), manufacturing output in the province remains more than 20% below the 2000 peak, while the comparable figure for Quebec is about 18%. Meanwhile, employment in Ontario edged up in 2011, while Quebec continued to shed manufacturing jobs over the past year. The sector’s share of total employment was at a record low of 12% in both provinces last year.

Given that manufacturing is still recovering from the cyclical downturn, we expect the rebound in factory output to continue. But the pace of growth will be constrained by the same issues that were weighing on the sector prior to the recession.

High-Flying Loonie Here to Stay
While some are quick to attribute the woes of the manufacturing sector to the appreciation of the Canadian dollar since 2002, there were other factors at play. Still, the exchange rate continues to be a significant headwind facing the sector. The Canadian dollar has been hovering in the 90-100 US cent range since mid-2009, and has remained there this year as foreign investors continue to ramp up their holdings of Canadian dollar denominated securities. What’s more, this range is likely the new norm, with medium-term risks largely tilted to the upside. Indeed, talk of Dutch Disease – whereby increased demand and prices for resources underpin a stronger currency, leaving other goods exports much less competitive – had been silenced to some extent during the recession, but is now back. This challenge has left manufacturers facing a double whammy of a stronger dollar and higher input costs – particularly energy. While many businesses have likely adapted to this high-loonie, high-energy cost environment, it still constrains the competitiveness of Canadian manufacturers. Accordingly, these producers must continue to make headway in a number of other areas that they have more control over.

Higher Productivity Can Help Boost Competitiveness
Over the longer haul, a desirable goal would be for producers to successfully compete based on innovation and high value added rather than purely on price. In the shorter term, however, attractive pricing becomes the more achievable lever. In turn, an ability to offer more competitive pricing boils down to either getting labour costs down (which are more under a firm’s control than many non-labour costs) or by increasing productivity. Unfortunately, growing productivity has been a challenge for Canadian manufacturers in recent years. Indeed, as illustrated in Chart 4 (above), productivity growth in Canada’s manufacturing sector during the 2000–07 period (prior to the recession) was 5%. This pales in comparison to other G-7 nations, where productivity grew by about 30%. After sliding during the recession, Canadian productivity has rebounded nicely, though at only a third of the rate seen in the United States.

Slower productivity growth has consequently left Canada with higher unit labour costs. As shown in Chart 5 (page 12), 10-15 years ago, Canada had a significant cost advantage over the United States. But not only has that
gap since closed, unit labour costs in Canada are now slightly higher than they are south of the border, with the competitive edge once enjoyed, now entirely eroded. This is a worrisome trend. With US unit labour costs now following a declining path and with risks tilted towards an even higher Canadian dollar, Canada’s relative cost position could deteriorate further. What’s more, all-in labour costs in the sector – including wages, benefits and taxes – are now higher in Canada, at $35.76 compared to $34.74 in the US, despite Canada’s public health care system. In fact, some regions in the US have even become more competitive with low-cost labour markets, with companies such as Carlisle Companies planning to bring production back to the US from China. This does not bode well for future expansion of manufacturing industries in Canada. Already there is evidence that businesses are feeling the pinch of producing in Canada, with Caterpillar recently closing a plant in Ontario and moving production to the United States.

Canada’s high cost of production is perhaps the most pronounced in the auto sector. Automakers looking to expand capacity or shift production to North America in order to reduce shipping costs and lower foreign exchange exposure are increasingly looking to the US and Mexico rather than Canada because they are more competitive. Case in point, Nissan, Honda and Mazda are investing in Mexico and Volkswagen is planning to open a new plant in either the US or Mexico to build Audi vehicles. Meanwhile, Ford just closed a plant in Canada. In 2011, Canada’s share of total North American production fell to 15.8%, marking the lowest level since 2003. Prospects for an improvement in that ratio are not great. Canada’s production mix is heavily skewed towards larger vehicles because it is unable to profitably produce smaller vehicles. With a large chunk of new investment likely to stem from the subcompact segment in the coming years, given that it is the fastest growing segment on the continent, Canada is likely to be left behind.

Labour negotiations in Canada between the union and the Detroit Three automakers are set to take place later this year. Similar negotiations in the US led to a two-tier wage structure – a tactic that is becoming more common in generating cost savings by employers. Media reports suggest that the Canadian Auto Workers’ union is not supportive of such a strategy.

**Invest or Shrink**

As such, Canada needs to step up its game – not only to attract new investment, but also to keep the manufacturing base that currently exists. While cost cutting will certainly help, businesses are also going to have to become more capital intensive. Profits for manufacturers bounced back quite strongly in the fourth quarter of 2011 following two quarters of declines, and we expect profits to continue to grow going forward. As well, businesses are sitting on elevated cash levels, which they can deploy once the timing is right. According to a recent survey by Statistics Canada, manufacturers intend to increase investment spending by 6.6% in 2012, which would mark the highest level since 2000. Investing in machinery and equipment (M&E) would be a good place to start – especially given the weak performance of Canadian businesses relative to their US counterparts over the past 20 years. Indeed, as shown in Chart 6 (above), M&E investment by the business sector in Canada has been well below that in the US, which partly explains the productivity gap. And now is an especially good time to invest since interest rates are low and the loonie is strong (a large portion of M&E is imported). Investing in research and development, as well as skills training, would also help to increase productivity and bring down unit labour costs.

**Export Diversification a Work In Progress**

Manufacturers can also improve their business position by diversifying their consumer base. While the US will always be an important market for Canadian-made goods given its proximity and size, reliance on a single market can be problematic – especially when that market is expected to grow at a modest pace at best over the next few years. Moreover, the US has actively been seeking to establish free trade agreements with countries around the world, suggesting that Canada will be facing some
hefty competition as more nations obtain access to the US market that Canada has had for some time now.

Accordingly, Canadian producers should work on tapping other growing markets so they are not so dependent on one economy. Some progress has been made over the past decade (Chart 7, above). In 2001, roughly 88% of all manufacturing exports were sent to the US. Since then, Canada has diversified its export portfolio, as America accounted for only 77% of manufactured exports in 2011. Asia and the European Union have picked up a large chunk of the difference. In particular, exports to China have risen by over 150% during the last decade. Moreover, while a larger share of Canadian-made goods is landing overseas, a larger portion is also being sold domestically. Indeed, in 2009, only 45% of all manufactured goods were exported – a 10 percentage point drop from 2000.

While Canadian manufacturers’ reliance on the US has diminished somewhat over the past 10 years, further diversification would be beneficial. The federal government has been working to negotiate free trade agreements with several countries around the world — including one with the European Union which should be finalized this year — which will aid in the transition to a more diverse export base. While there can be winners and losers, research shows that trade agreements deliver a benefit to both countries in terms of increased productivity — an added bonus for manufacturers.

**Limited Help Expected From the Government**

Governments can help support the sector in other ways as well, as they have over the past few years. The federal government has reduced the corporate income tax rate from 21% in 2008 to 15% in 2012. In Ontario, the capital tax was eliminated, which has also benefited the province’s manufacturing sector. However, with elevated debt levels, governments at all levels will be focused on shoring up their balance sheets, so any meaningful support may be hard to come by in the near term. In fact, while the corporate income tax rate in Canada is considerably lower than in the US (35%), this advantage is not a sure thing going forward. Indeed, the US government is considering reducing its corporate income tax rate, while some provinces in Canada are contemplating increasing them.

**Competitiveness to Make or Break the Sector**

The bottom line is that the Canadian manufacturing sector is under a great deal of competitive pressure, and must invest in innovative practices and technologies that will help boost productivity and lower unit labour costs. Overall, we expect the sector to continue to bounce back from the cyclical downturn, with the machinery and auto and parts sectors continuing to record healthy gains, along with the computer and equipment industry. However, the pace of growth will be limited. We expect manufacturing output to grow by 3-4% this year and next, suggesting that the sector’s share of total output is not likely to exceed the pre-recession rate of 14% in the foreseeable future, let alone return to the 18% seen a decade ago. This doesn’t bode well for employment in the sector, as it will not likely rebound to the levels seen prior to the recession. Still, given that manufacturing job gains have been scarce during the recovery thus far, we expect the sector to contribute to employment growth over the next couple of years as manufacturers become more comfortable expanding and hiring in the economic environment. As a share of total employment, factory jobs will likely make up 10-11% of the national total over the forecast horizon.

Notes: