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## A reshaping and rebalancing of global growth

Chief Economist Dr. Warren Jestin says the generally optimistic economic forecast for 2005 is tempered by massive foreign exchange rate realignments and high energy prices. doing business with Scotiabank's Internet-based foreign exchange trading system.

**Warren Jestin,**  
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**A**s 2004 draws to a close, thoughts in the business community inevitably turn towards economic prospects for the coming year.

Dr. Warren Jestin, Scotiabank Senior Vice-President and Chief Economist, says there's enough global momentum to expect that 2005 will be a good year overall. However, he predicts slightly lower-than-expected economic growth in response to competitive readjustment, high energy costs, and the upward drift in U.S. interest rates.

"As the primary fuel for international growth, the high price of crude oil is a big hurdle for the global economy to clear," Jestin explains.

"Oil prices are expected to average around U.S. \$39 per barrel in 2005, roughly in line with the \$41 average anticipated in 2004, but effectively double the level of prices at the beginning of the decade. This sustained run-up in oil prices is changing growth prospects in favour of countries that produce energy as opposed to those that consume energy," he continues. "Canada and Mexico, key energy exporters to the hungry U.S. market, should continue to benefit from strong shipments and high prices."

A list of factors — recurring geopolitical tensions and enormous structural imbalances in the U.S. fiscal and current accounts, a cooling of red-hot conditions in the housing market, high levels of household indebtedness and competitive currency realignments — are contributing to the slower pace of global economic growth. The world's powerhouses, China and the United States, are now expected to advance 8.5% and 2.9%, respectively, in 2005, still solid performances, but slower than the year before.

"China is leading the world in economic growth by a very substantial margin," Jestin explains. "While we used to think of China as an outsourcing market, it is increasingly becoming a major consumer of goods. China is now the third largest importer in the world."

"The U.S. economy had been posting robust growth coming into 2004, fuelled by low interest rates, tax cuts and government spending increases. But consumers have little pent-up demand after a decade-long shopping spree, and, given the moderate pace of job creation, capital investment and exports will play a much greater role in driving economic growth over the next year. A sharply weaker U.S. dollar will help re-invigorate U.S. manufacturing activity and foreign-bound shipments."

Jestin indicated that "the massive U.S. trade deficit, which now exceeds U.S. \$650 billion (5.6% of GDP), will be difficult to bring down with the level of imports 50% higher than export receipts. This is definitely a concern for investors. Slower growth will also make the Federal Reserve more cautious in raising interest rates." Jestin expects



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about two more 25 basis points increases in interest rates in the opening months of 2005 — to a still-low 2.75% — followed by a pause in policy tightening.

## Canadian economy poised for a good — not great — year

Canadian GDP growth in 2005 is forecast to expand 2.5%, down slightly from the 2.7% gain in 2004. The economy is experiencing stiffer competitive headwinds after the most rapid appreciation on record has pushed the Canadian dollar to over 81 cents (U.S.). Exports have already softened, particularly in the manufacturing sector.

The Canadian dollar is expected to remain strong, with additional appreciation in 2005 boosting the Loonie's fortunes into the 85-90 cent (U.S.) range, against the backdrop of a progressively weaker U.S. dollar.

With energy prices ratcheting higher, growth over the next year will increasingly be tilted towards the Western provinces. The upswing in non-energy resource prices offers a broader benefit, and B.C.'s long-term outlook remains upbeat given its gateway position to the rapidly expanding Pacific Rim and preparations for the 2010 Winter Olympics.

Manufacturers in Quebec and Ontario will be facing higher input costs, a stronger Canadian dollar and more moderate U.S. growth. Buoyant resource prices will benefit Atlantic Canada this year and next, helping to offset provincial fiscal restraint, a slow rebound in tourism and increasing offshore competition for new call centre activity. The boom in residential construction is expected to ease across Canada in 2005, but infrastructure investment should remain buoyant.

## Exports key to Canadian growth in 2005 and beyond

Canada's external trade continues to be a major factor in determining the country's economic performance — and Jestin advises Canadian businesses to tap opportunities to build foreign exports or lose ground to lower-cost producers in international markets.

"Canada's dependence on the U.S. market has risen over the past decade, with roughly 85% of exports now going there compared with 75% in the early 1990s," Jestin explains. "During this period, solid U.S. growth, a protracted slide in our exchange rate and rising demand for Canadian energy fuelled a five-fold increase in our bilateral trade surplus. However, our share of U.S. imports actually has been edging down since the mid-1990s, falling below 18% in 2003 for the first time in 16 years. Excluding energy products, which make up 19% of total U.S.-bound foreign sales compared with about 11% in the early 1990s, the decline has been much larger."

Beyond the resource sector, Jestin points out that Canada's orientation to overseas markets has been negligible or declining.

"The share of foreign sales going to Europe and Japan has fallen to 7% from 10% a decade ago — partly a reflection of the lacklustre economic performance of these regions. Less than 1% of Canadian exports are destined for Mexico, NAFTA's growth leader, and only 2% go to China, which also has become our fourth largest foreign supplier. More generally, only 6% of Canadian exports — mostly commodities — go to Asia, a region that collectively accounts for 16% of our imports. This imbalance will continue to grow, and our hefty trade surplus will ultimately erode, unless Canadian producers aggressively nurture markets in this fast-growing region," concludes Jestin.

While Canada's economic outlook is positive, substantial challenges remain — including making health care more sustainable and catching up on infrastructure investment. Focusing on cost and productivity advantages will undoubtedly be the strategy for Canadian business next year and beyond.



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