Canada’s central bank expresses trepidation over economic downturn

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Canada’s economic output stalled in October, according to figures released last week. This followed a contraction of 0.5 percent of Gross Domestic Product in September, indicating that Canada’s economy is struggling to pull out of the recession it experienced in the first half of 2015.

In all, Canada’s economy has failed to grow in seven of the year’s first ten months.

Recent weeks have witnessed a precipitous fall in the value of the Canadian dollar, as the country’s economy is rocked by the collapse in commodity prices and by anemic growth in the US.

In the wake of the US Federal Reserve Board’s Dec. 16 decision to increase interest rates, the Canadian currency declined to US $0.72, its lowest level in eleven years. Analysts are predicting the currency will soon fall below the 70-cent mark. It has already lost 17 percent of its value this year, falling to an eleven-year low against the US dollar.

The deepening economic slump is being driven by the global crisis. The collapse in oil prices, which have been halved to $36 per barrel over the past twelve months and are down from over $100 over the past year and a half, together with a similar sharp slide in other commodity prices, have hit Canada’s resource- and export-dependent economy hard. The economic downturn in China, whose demand for raw materials helped maintain commodity prices, has played a major role in this.

The anticipated boost to exports as a result of the Canadian dollar’s sharp fall has not materialized, mainly because other currencies, such as the Mexican peso, have declined at a similar pace against the US dollar. Mexican exports to the US are rising steadily, while Canada’s have been stagnant for some time. Last month, Ottawa was overtaken as Washington’s largest trading partner by China.

A recent Bank of America/Merill Lynch report noted that capital outflows from Canada are taking place at the fastest rate among developed countries. In a sharp reversal from twelve months ago, when the Canadian economy saw an inflow of capital chiefly in the energy sector equivalent to 4.2 percent of GDP, it is now experiencing capital outflows equal to 7.9 percent.

Even worse could still be to come. There are mounting fears that a collapse of the overheated housing market, or a series of bankruptcies among oil producers in Alberta due to the decline in the currency and oil prices, could provoke a broader economic crisis.

Responding to the darkening clouds over the economic outlook, Bank of Canada (BoC) Governor Stephen Poloz gave a speech December 8 laying out measures the bank would be prepared to take in the event of a major crisis. Having reduced interest rates twice already this year from 1 to 0.5 percent with no discernible impact on the economic slide, Poloz declared the bank could follow the example of the European Central Bank (ECB) and introduce negative interest rates. He therefore announced a reduction in the Bank of Canada’s “floor interest rate,” below which it will not lower rates, slashing it to -0.5 percent. This goes significantly further than during the 2008-09 crisis. Then the bank declared it would be prepared to lower its prime lending rate to as little as 0.25 percent.

Poloz also said that in the event of a major crisis the bank could resort to “quantitative easing,” that is, the making available of billions in cheap credit to the financial elite to fund stock market speculation. While such programs have been pursued by the ECB and above all by the US Federal Reserve, such a step would be unprecedented for the BoC.

The central bank chief sought to reassure his audience, and the markets, that he was simply outlining future policy options for the bank. “Today’s remarks should in no way be taken as a sign that we are planning to embark on these policies,” he claimed. “We don’t need unconventional policies now and we don’t expect to use them.”

Poloz based this assertion largely on the claim that fiscal stimulus implemented by the government tends to be more effective than monetary policy. On this basis, he has welcomed the Liberal government’s intention to run budget deficits to fund an infrastructure investment program that will see up to an additional $25 billion invested over the next three years.

Yet in the less than three months since the Liberals won the federal election with infrastructure spending as one of their key campaign pledges, the government’s financial position has significantly worsened. This has led Prime Minister Trudeau to abandon the Liberals’ promise to limit the federal budget deficit to $10 billion per year in their first two years in office. Senior government officials are now saying only that they will ensure that the total national debt-to-GDP ratio continues to decline. This would allow annual deficits of up to $25 billion per year.

While the government is giving itself some leeway to run larger deficits in the short term, Trudeau insisted in a recent interview that the Liberals’ commitment to balance the budget prior to the next election in 2019 is “cast in stone.” This means that the government will have to go substantially beyond the $6 billion in annual “savings” it pledged to find in the final year of its mandate.

Compounding the threat facing workers from further austerity is a series of troubling developments that could trigger even greater economic turbulence.

Household debt reached record levels in the third quarter, rising to 163.7 percent of disposable income from 162.7 percent in the second quarter. This places Canada among the countries with the highest level of household debt in the world.

Poloz acknowledged December 15 that rising debt levels pose a significant risk to the property market. BoC figures show a dramatic expansion of households, especially among younger adults, in extreme indebtedness, with 8 percent of households now having debt worth more than 350 percent of gross income. The rate of “extremely indebted” has actually doubled since the 2008-09 economic crisis.

The Bank’s “financial systems review” described the risk of a price drop in the property market as “elevated” and admitted that the consequences of such a development would be “severe.” The other elevated risk it mentioned was the sharp economic contraction experienced by China and other “emerging markets.”

Earlier this month, the government announced measures to try to cool the overheated housing market in Toronto and Vancouver. But commentators fear that this could have the unintended consequence of accelerating the decline in housing prices in Alberta, Canada’s main oil-producing province, potentially leading to a spike in personal bankruptcies and mortgage defaults.

Alberta has undergone a sharp economic contraction this year, with final figures for 2015 expected to show a 1.1 percent decline. In 2014, 35.7 percent of Alberta’s GDP was derived from capital investment, three times the national average, and the energy sector accounted for 60.7 percent of this. The Economics Society of Northern Alberta gloomily predicted that the oil price drop, which has prompted billions to be cut from the oil companies’ capital spending budgets, will create a tax revenue deficit for Alberta of $11 billion per year for each of the next 3 years.

A total of 63,800 workers lost their jobs in the first eight months of the year in Alberta, almost as many as in the whole of 2009 at the height of the global downturn.

According to the latest predictions from Goldman Sachs, oil prices could drop as low as US$20 per barrel. Such levels could force many of the already struggling oil producers in Alberta’s tar sands, where production costs are among the highest in the world, into bankruptcy or make them prime candidates for takeover by foreign competitors keen to seize the opportunity afforded by the cheapened Canadian currency.

The federal Liberal government is so concerned about the state of Alberta’s economy that it is establishing a council of Canadian and high-profile international politicians, economists and businessmen to advise it on how growth can be sustained in Alberta’s economy.

A similar crisis is unfolding in Newfoundland, another oil-producing province. Faced with a provincial budget deficit that has ballooned to $1.9 billion, the newly elected Liberal provincial government has announced a series of emergency measures, including a hiring freeze, and is vowing to take further austerity measures, including potential wage and job cuts, early in the new year.