

# Global Economic Environment

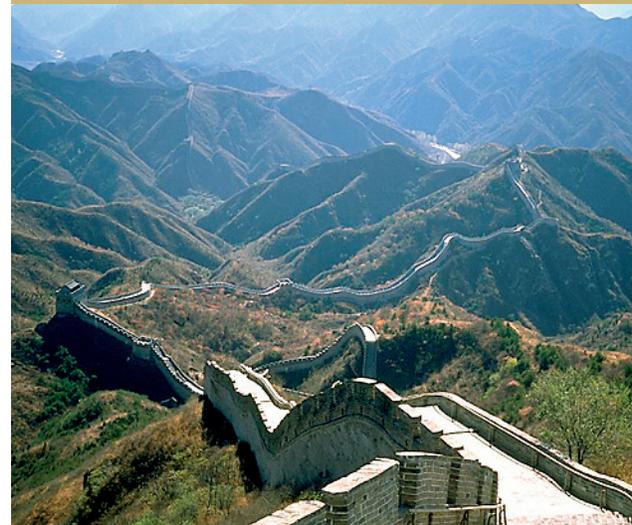
Global economic recovery from the recent recession continued throughout 2011. The International Monetary Fund (IMF) estimates that most major economies had positive GDP growth in 2011. However, global economic uncertainty also persisted throughout the year due to sovereign debt troubles in Europe, unrest in the Middle East and slowing economic growth in China.

Commodity prices fared well last year, supported by solid demand from China and India. The Bank of Canada commodity price index grew by 11.6% in 2011, with the most significant gain coming in agricultural commodities (+34.8%). Energy and minerals also showed strong growth. Brent crude oil rose from US\$79.61/barrel in 2010 to US\$111.26/barrel last year.

Globally, the IMF estimates GDP growth was 3.8% in 2011 and is forecasting 3.3% growth in 2012.

## Europe

Economic fragility in Europe, fuelled by sovereign debt woes in Greece, Ireland and a number of southern European nations, curtailed a robust recovery last year. GDP growth weakened throughout Europe as the year progressed. The IMF estimates that euro area GDP grew by 1.6% in 2011. The sovereign debt troubles that first emerged in Greece, and spread to Portugal, Ireland and Spain in 2010, reached Italy and France in 2011 (see discussion on pages 9-10). In January 2012 both Fitch and Standard & Poor's (credit rating agencies)



## GDP Growth (%)

	2011e	2012f
World .....	3.8	3.3
Canada .....	2.5	2.2
United States.....	1.7	2.3
Brazil .....	2.9	3.0
China .....	9.2	8.2
India.....	7.4	7.0
Japan .....	-0.9	1.7
United Kingdom.....	0.9	0.6
Euro Area .....	1.6	-0.5
France .....	1.6	0.2
Germany .....	3.0	0.3
Italy .....	0.4	-2.2
Spain.....	0.7	-1.7
Russia .....	4.1	3.3

e: estimate f: forecast

Source: Canada - Statistics Canada (2011) and average forecast of major Canadian banks (2012); U.S. - Bureau of Economic Analysis (2011) and Survey of Professional Forecasters, U.S. Federal Reserve Bank of Philadelphia (2012); all other jurisdictions - International Monetary Fund, January 2012.

downgraded the debt of a number of European nations, including France, Spain and Italy, as well as the debt of the European Financial Stability Facility, which is responsible for coordinating euro area bailout efforts. Greece's solvency remains a concern but steps have been taken to strengthen the country's fiscal situation. On February 20 euro area finance ministers approved the terms of a second bailout package for Greece, worth 130 billion euros, and on March 9 the Greek government and private bondholders completed a bond swap deal intended to reduce the value of the nation's outstanding privately held debt by 53.5%. Nevertheless, a European recession in 2012 remains a distinct possibility, which will be a drag on global growth. At this point the IMF is forecasting a mild recession in 2012 with a 0.5% decline in GDP in the euro area.

## EUROPEAN SOVEREIGN DEBT

Sovereign debt has been a problem in many developed countries, especially in Europe and Japan, over the last 15-20 years. Euro area countries, though, took advantage of economic boom times early in the millennium to reduce their debt burdens. Gross government debt-to-GDP ratios shrunk by an average of 6.0 percentage points across the region's current members over the 1998 to 2007 period, according to IMF data. However, the average debt-to-GDP ratio was still in excess of 50%. During the recent recession debt-to-GDP ratios began to increase again as revenues shrank and expenditures grew, due mainly to stimulus measures to counter recessionary impacts. Over the 2007 to 2011 period the debt-to-GDP ratios across the euro area grew by an average of 22.9 percentage points, including increases of 60.1 and 84.3 percentage points in Greece and Ireland respectively.

With the large growth in debt burdens, investors began to lose confidence in the ability of a number of European governments to repay their debt obligations. Accordingly, the sovereign debt crisis in Europe has dominated global economic news for two years, casting an ominous shadow over the economic recovery. Although European leaders moved to stem the crisis in 2011 and early 2012, the effectiveness of the measures remains uncertain and the issue continues to threaten economic stability in Europe and around the world. The uncertainty and economic risk associated with this is evident in the spread between the yields on 10-year government bonds in the most troubled European countries and the yield on German government 10-year bonds.

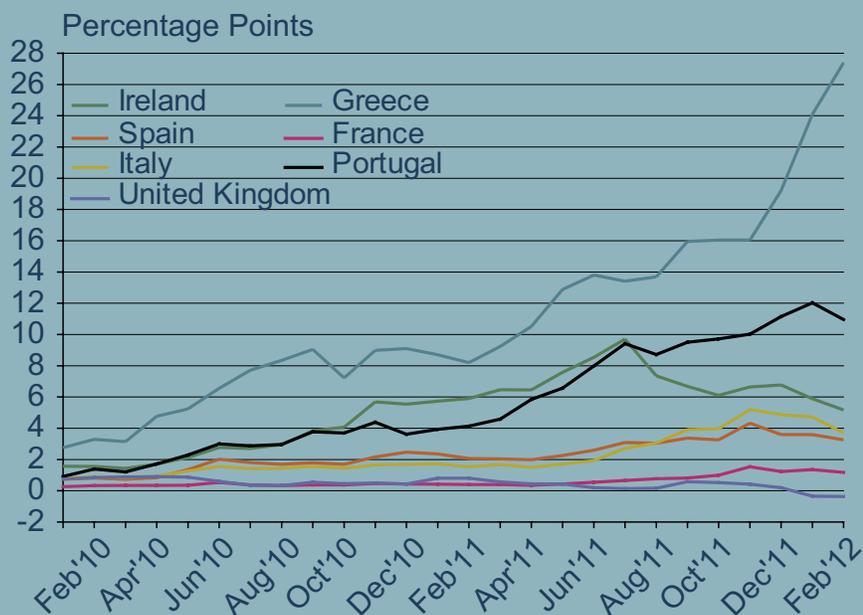
This spread is a widely followed gauge of sovereign debt default risk for European countries. In Europe, German bonds are equivalent to U.S. Treasuries in terms of their status as a "safe haven" asset in times of uncertainty. An increase in the spread is considered by most experts to be a reflection of the market's assessment of the country's growing risk of debt default, due to any number of factors but most importantly fiscal mismanagement.

Lately, the spread has also become something of a gauge of the exposure of a country's banks to the debt crises in southern European countries, most notably Greece, Portugal and Spain. This may be because investors believe that a country's banks hold dangerous levels of troubled sovereign debt and, should a serious sovereign debt event occur, these banks may need to be bailed out by their government. This would require governments to take on additional debt obligations in a depressed economic environment. The best example of this phenomenon, in recent months, was the uptick in French debt yields at the end of 2011 (see chart).

As of February 2012, the spread between the yield on domestic 10-year bonds and the yield on German bonds was still on the rise for Greece, while Ireland, Italy, Spain and even Portugal recently attained a reprieve (see chart). Since the ordeal began in

## EUROPEAN SOVEREIGN DEBT

### Yield Spreads on 10-year Bonds between Select European Countries and Germany



Source: European Central Bank

late 2009, the spread between Greek and German bonds has skyrocketed by 24.3 percentage points, to reach 27.4 percentage points. In 2011, across the most impacted nations—Ireland, Greece, Spain, Italy and Portugal—the spread rose from an average of 4.5 percentage points in January to 9.1 percentage points by December. As of February 2012 the average spread for these countries had climbed to 10.1 percentage points. It should also be noted that current and future bailout commitments are causing investors to search for safe European assets outside of the stronger euro area nations, as evidenced by the negative spread between United Kingdom and German bonds in recent months (see chart).

In tangible terms, the sovereign debt crisis in Europe is forcing banks to reduce their lending and exposure to riskier loans. Due to the inverse relation between bond yield and price, as the yields on sovereign debts climb the market value of those bonds tend to fall. Consequently, European banks have seen a reduction in the value and quality of their assets. This is forcing banks to reduce lending to meet capital requirements, which has a real impact on investment and employment decisions of firms. As a result, Europe will be hard pressed to avoid even a modest recession in 2012.

## Asia

Economic activity appeared to be slowing in both China and India in late 2011, however, GDP growth was still high. China reported its lowest GDP growth rate in over three years in the fourth quarter of 2011, but at 8.2% it remained markedly high and exceeded expectations. The story was similar in India; fourth quarter growth in 2011 was 7.4%, more than double the 3.6% third quarter growth but in line with growth in the first two quarters. Conversely, in Japan the economy rebounded in the third quarter of 2011 after being hit hard by natural disasters in March 2011, which curtailed growth and disrupted global supply gains. Third quarter growth was 7.0% at an annual rate, after three straight quarters of negative growth. Fourth quarter growth, though, was more in line with recent trends at -0.8%. The IMF is estimating GDP growth of 9.2% in China, 7.4% in India and -0.9% in Japan for 2011. The 2012 forecasts are for 8.2%, 7.0% and 1.7% growth, respectively.

## United States

The U.S. economic recovery, after weakening at the beginning of the year, showed signs of resilience towards the end of 2011. Quarterly real GDP growth climbed from 0.4% in the first quarter of 2011 to 3.0% in the fourth quarter (see chart). For the year as a whole U.S. real GDP increased by 1.7%, led by gains in exports, investment and consumer spending. Declining government spending and growth in imports negatively impacted GDP growth.

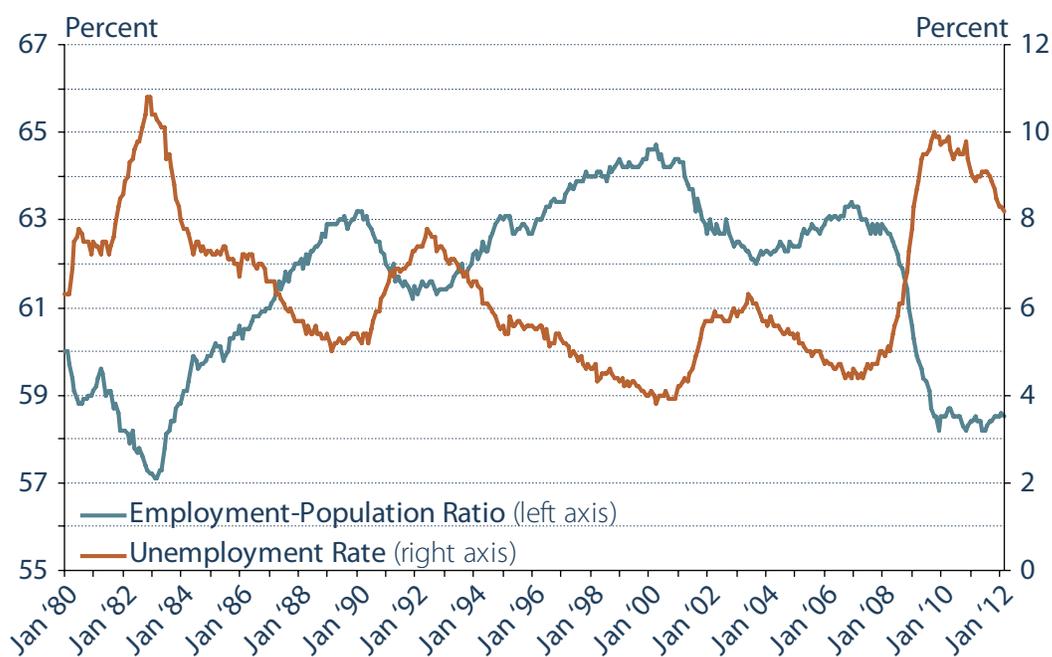
The employment situation showed signs of improvement throughout the year, with monthly employment gains averaging roughly 150,000 and the unemployment rate falling from 9.1% in January to 8.5% by the end of the year. As a result, 1.8 million jobs were created during the year and annual average employment increased by 1.2%. Yet, in spite of these improvements, other labour market indicators remain depressed, underlining the damage done during the 2007 to 2009 downturn. The participation rate in the U.S. has dropped to a level not seen since the mid-1980s, and recent improvements in the unemployment rate have not been met by corresponding improvements in the employment-population ratio (see chart). Additionally, both of these measures also remain at levels not seen since the mid-1980s.

The depressed labour market, political wrangling over fiscal and financial reform and growing concern over sovereign debt in Europe all combined to create high levels of uncertainty in the U.S. economy in the second half of last year. As a result, the economic recovery remains fragile, as evidenced by the Federal Reserve's announcement at the end of January 2012 (and reiteration in early March) that economic conditions will likely necessitate the central bank keeping interest rates low through late 2014. The Federal Reserve has had a target range of 0% to 0.25% on its federal funds rate since mid-December 2008, which has significantly contributed to

low interest rates across the U.S. economy (e.g. the yield on 10-year U.S. Treasuries, a benchmark for a large proportion of interest rates in the economy, has averaged 2.99% since December 2008 and was just over 2% as of the end of March 2012). These low interest rates, though, should help spur investment and spending as the recovery strengthens.

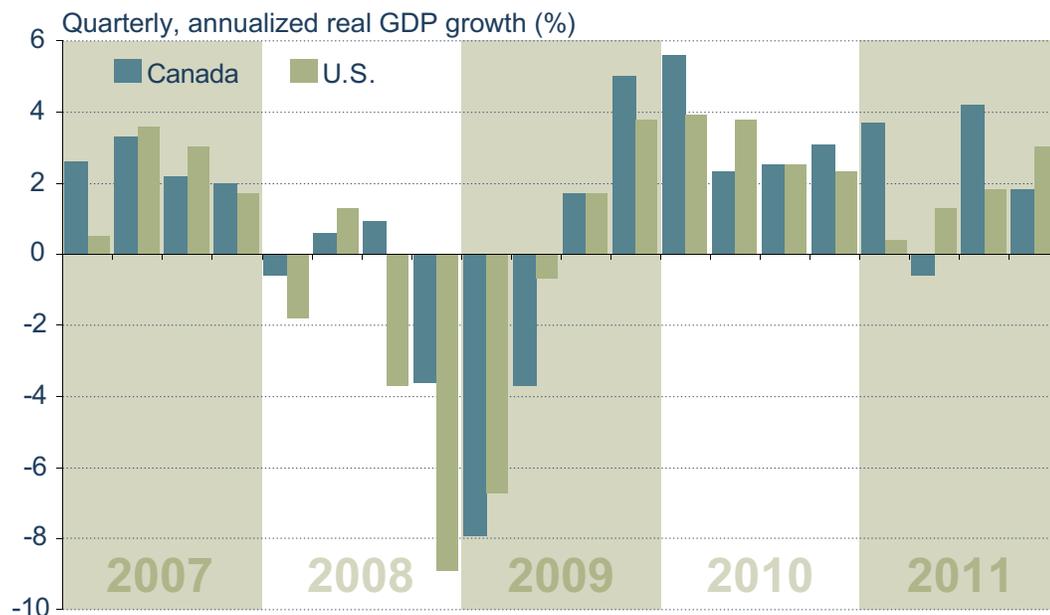
The Federal Reserve Bank of Philadelphia Survey of Professional Forecasters is projecting GDP growth of 2.3% and employment growth of 144,100 jobs per month in 2012.

## U.S. Labour Market



Source: U.S. Bureau of Labor Statistics

## Quarterly GDP Growth



Source: U.S. Bureau of Economic Analysis; Statistics Canada

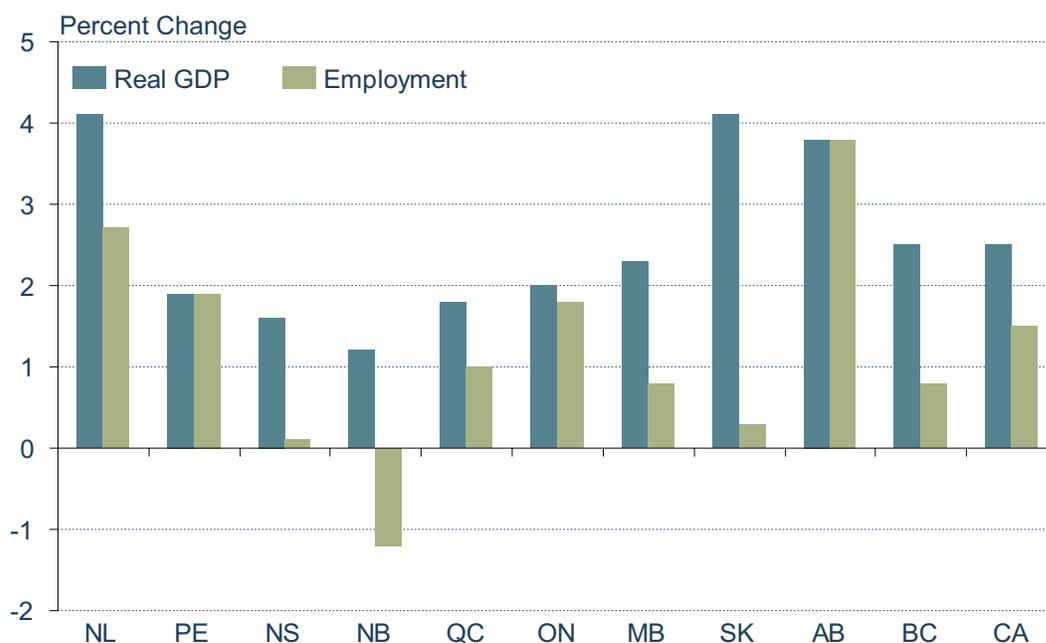
## Canada

Canada's economy fared better than the U.S. and most European nations in 2011, benefitting from strong commodity demand from developing countries such as China and India. Despite an annualized decline in real GDP of 0.6% in the second quarter of the year, the economic recovery was relatively robust as quarterly, annualized real GDP growth was positive in the other three quarters, with a high of 4.2% in the third quarter (see chart). Overall, real GDP grew by 2.5% in 2011. Labour market improvements underscored the rally, as the unemployment rate fell from 7.7% in January to a 2011 low of 7.2% by September. Employment had returned to pre-recession highs by January 2011.

Although recovery in Canada, as a whole, was strong for the majority of 2011, different regions of the country had very different experiences. Provinces with large manufacturing sectors were impacted by the disruption in global supply chains stemming from the March earthquakes and tsunamis in Japan, particularly in the second quarter. The Conference Board of Canada estimates that almost all provinces experienced a slowdown in GDP growth during that quarter, with Quebec, Ontario, Alberta and New Brunswick actually experiencing contraction. Overall, the recovery has been strongest in resource-rich provinces (see chart). A survey of major forecasters estimates real GDP growth in the provinces was highest in Saskatchewan

and Newfoundland and Labrador (+4.1%), followed by Alberta (+3.8%). Growth was estimated to be lowest in New Brunswick (+1.2%) and to have averaged +2.0% across the remaining provinces. Employment numbers further reflect the diversity of provincial economic performance, as Newfoundland and Labrador and Alberta experienced both the largest declines in their unemployment rates (-1.7 percentage points and -1.0 percentage point, respectively) and the largest increases in employment (+2.7% and +3.8%, respectively) in 2011.

## GDP and Employment Growth, 2011



Source: Statistics Canada; Consensus of the major banks and Conference Board of Canada

Risks to a sustained recovery still exist for Canada, the most pressing being possible direct and secondary effects from a recession in Europe. However, continued strong growth in developing markets and a recovering U.S. economy should continue to provide a buffer for the Canadian economy. As of April, an average of forecasts from major Canadian banks projects GDP growth of 2.2% in 2012.