

Global Economic Environment

The Canadian dollar has appreciated rapidly this year



World GDP growth remained above 5% in the first half of 2007. Slower growth in the U.S., the European Union and Japan was counterbalanced by robust performances in China, India and Russia. The economies of the U.S., the European Union and Japan were restrained by the U.S. housing slump, high oil prices and recent financial market turmoil. Developing countries, particularly China, India and Russia are expected to continue their strong growth for the remainder of 2007, and into 2008, as they benefit from rapid globalization. Overall, world GDP growth is expected to moderate this year and next.

World Real GDP Growth (%)

	2006	2007f	2008f
WORLD	5.4	5.2	4.8
United States	2.9	2.2	2.1
Canada	2.8	2.5	2.5
European Union	2.8	2.5	2.1
Japan	2.2	2.0	1.7
China	11.1	11.5	10.0
India	9.7	8.9	8.4
Russia	6.7	7.0	6.5

f: forecast
Various sources

United States

The U.S. economy has shown surprising resilience during the first three quarters of 2007. Despite the slumping housing sector and credit market turmoil due to the sub-prime mortgage crisis, GDP grew by 3.8% and 4.9% in the second and third quarters respectively. Growth was led by strong gains in exports and non-residential investment. Solid gains in consumer and government spending were also recorded. These positive factors more than offset a sharp decline in residential investment.

U.S. labour markets continued to expand in 2007 with job gains averaging 118,000 per month during the first eleven months. However, this was down from average monthly gains of 185,000 during the same period last year. Job gains matched labour force growth and as a result, the unemployment rate remained steady near 4.7%.

Residential investment declined by nearly 20% at annualized rates in the third quarter of this year and many economists expect 2007 house prices to decline on a year-over-year basis for the first time since the 1930s. High inventories of unsold homes, tighter lending standards and falling prices suggest that the housing sector will remain weak for several years.

Anxiety over the collapse of the housing sector and the sub-prime mortgage crisis (see discussion opposite) prompted the Federal Reserve Board (Fed) to cut interest rates by one half of a percentage point in September—the first change in rates since June 2006. This was followed by a further cut of a quarter-point on October 31.

The U.S. dollar depreciated by roughly 10% against the currencies of its major trading partners between late December 2006 and early December 2007. Lower interest rates, continued concern over the high current account deficit and spreading economic anxiety over the sub-prime mortgage collapse were all factors behind the downward pressure on the U.S. dollar this year.

The U.S. economy is now entering a period of turbulence as a result of a deepening housing slump and high oil prices which are likely to dampen consumer spending. However, the economy still has considerable momentum and the lower U.S. dollar should boost exports. Overall, U.S. economic growth is expected to average roughly 2.2% in 2007 and 2.1% in 2008.

Canada

A robust global economy, strong commodity prices and considerable momentum in domestic demand were the

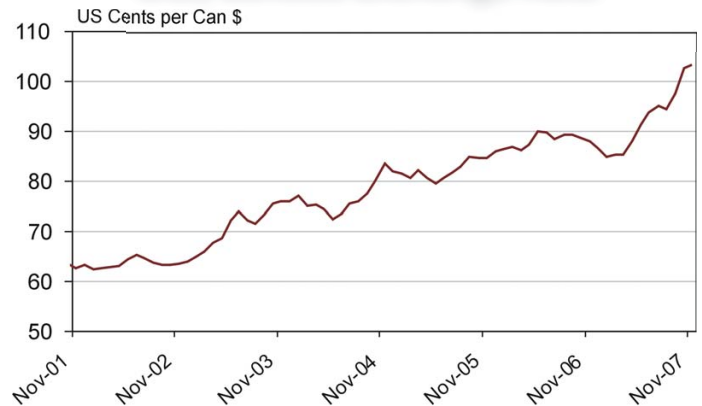
drivers of Canadian economic growth in the first three quarters of the year—real GDP increased by 3.9% and 3.4% in the first and second quarters respectively before slowing to 2.9% in the third quarter. Economic growth was widespread with gains in consumer spending, exports, and business and residential investment.

Labour markets continued to improve with employment up by 2.3% during the first eleven months of this year compared to the same period in 2006. Strong labour demand and demographic constraints on supply are resulting in tight labour markets. The seasonally adjusted unemployment rate was 5.9% in November, down from 6.2% at the beginning of the year.

With the economy operating near full capacity, escalating inflation remains an ever present concern for the Bank of Canada. In order to stem inflation, the Bank raised the target for the overnight rate by 0.25 of a percentage point in July. However, in recent months the dollar has increased sharply and the Fed has started cutting U.S. interest rates. These factors prompted the Bank of Canada to lower the overnight rate by 0.25 of a percentage point to 4.25% on December 4.

The Canadian dollar has appreciated rapidly this year, increasing from near 86 cents US per Canadian dollar at the start of the year to a peak of US\$1.10 per Canadian dollar in early November before retreating to around 98 cents US in early December. General weakness in the U.S. dollar and strong mineral and oil prices continue to support the Canadian currency.

U.S./Canada Exchange Rate



Bank of Canada

The strong economic performance this year has not been evenly distributed across the country. While booming commodity markets are producing robust growth in resource-rich regions, the high dollar and slowing U.S. economy are troublesome for Central and Eastern parts of Canada, in particular Ontario and Quebec. Overall, consumer spending is expected to remain strong due to tight labour markets, income gains and relatively low interest rates. Business investment is expected to remain strong as well, but the high dollar and slowing U.S. economy are expected to dampen exports. Most forecasters currently expect real GDP growth to average 2.5% in both 2007 and 2008.

U.S. Sub-prime Mortgage Crisis

Sub-prime mortgages are high risk loans offered to borrowers with below average credit ratings, often issued under lax lending standards. These mortgages became popular in 2005 and 2006 as house prices were rising. The U.S. sub-prime mortgage crisis began with a sharp rise in residential foreclosures in 2006 as many customers faced higher interest rates with mortgage renewals at a time when house prices were starting to fall.

In late 2006 foreclosures on sub-prime mortgages began to skyrocket. In August 2007, serious delinquencies for sub-prime mortgages with adjustable rates had reached 16%, roughly triple the recent low in mid-2005.

The impact of this crisis was far reaching within financial markets. Many of the sub-prime mortgages were sold to Wall Street firms that pooled them with other loans in structured debt products known as asset-backed commercial paper (ABCP). These pooled products were sold on the open market as high yield “secure” investments. Many firms which rely on trading these products on a regular basis to meet maturing debt obligations faced a credit squeeze this past summer when the market for asset backed commercial paper seized

up in response to rising delinquency rates for sub-prime mortgages.

Many banks, mortgage lenders, real estate investment trusts and hedge funds have already taken large losses as a result of mortgage asset devaluation. In addition, with little or no demand for ABCP type products, investors continue to hold these financial assets until the market decides how to accurately price them. In response, several central banks injected money into financial markets to ensure access to funds for entities with illiquid mortgage-backed assets. The Fed has cut interest rates and lending standards in the U.S. mortgage market have tightened sharply. Recently, a consortium of U.S. banks established a fund with plans to pool mortgage-backed assets to try and head off pressure for investors to dump these assets at sharply reduced prices.

The U.S. housing sector is in a steep decline and credit conditions around the world have tightened, limiting firms’ access to credit and slowing world growth. Nevertheless, many economists feel economic fundamentals are strong and do not expect this crisis to have a substantial long-term impact on growth.