Economic Viewpoint
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Québec could avoid a steep economic decline

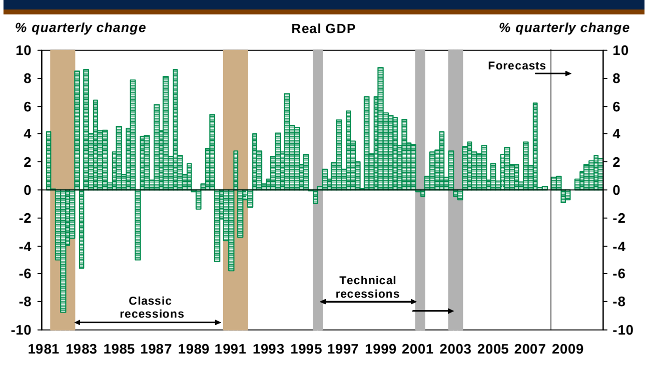
However, a mild recession seems likely

While the U.S. is already in recession, the risk that Canada, and by extension Québec, will also slip into recession is now high. In this period of global economic and financial turmoil, each statistic published is tracked closely in order to detect the first signs of weakness that would see Québec's economy slip into a phase of decline. Given the darkening outlooks on the economy, the period of stagnation that has settled in since mid-2007 will give way to a slight contraction in the real GDP until spring 2009. Even if Québec's economy were to slip into a recession, it will be mild compared to those we experienced in the early 1980s and 1990s. In fact, a review of the main indicators shows that the overall context was much gloomier during the last two genuine recessions. For the time being, the statistics are pointing to some weaknesses, but they also show some areas of resistance. The figures are often released with some time-lags, which can cloud the diagnosis. Even if the situation is expected to deteriorate in the months ahead, most of the key variables are likely to remain far from the critical points usually associated with a classic recession. If the situation continues in the United States, Québec's economy could deteriorate further.

QUÉBEC'S BUSINESS CYCLES

A period of recession is generally defined by at least two consecutive quarters of contraction in the real GDP. A limited scope and a less significant deterioration of the labour market is what differentiate a technical recession from a genuine recession. Québec has experienced two classic recessions and three technical recessions since the early 1980s (graph 1). The recession of 1981-1982 was particularly severe, given its scope: a 15-month period from May 1981 to July 1982. While economic activity fell sharply during this period, it did not take too long for real GDP to recover any lost ground. The situation was much different during the recession of 1990-1991, when the contraction in economic activity was not nearly as steep but the recovery took much longer to gain traction. In fact, the economy had started to decline in March 1990 and the recovery started to shape up only two years later, after a lengthy period of stagnation.

Graph 1 – Classic and technical recessions



Sources: Institut de la statistique du Québec and Desjardins, Economic Studies

Since 1981, Québec has gone through three technical recessions where the decline in activity was not widespread enough over an extensive period of time to qualify as a genuine recession. The first in 1995 was mild in scope, but it still stretched over a seven-month period. The crisis with the Mexican peso that led to a sudden spike in the value of the Canadian dollar, the second Martin budget and political instability in Québec were at the core of this contraction. Real GDP started to contract in June and did not recover until the end of the year. The 2001 technical recession was more pronounced, but its duration was similar (January to June). Lastly, in 2003, two consecutive quarters of declines in real GDP were recorded in the first and second quarters (-0.5% and -0.7%, at an annual pace). While this period is in line with the technical definition of a recession, the contraction was insufficient to call it a classic recession.

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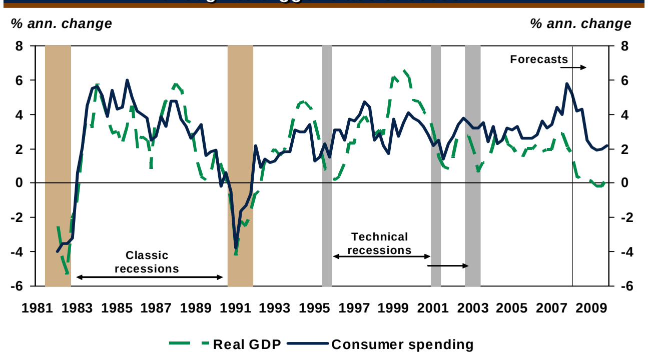
Since mid-2007, real GDP has shown barely positive growth, and no drop has been recorded yet. Let's see if we have all of the ingredients that, when combined, could see the anticipated contraction in Québec's economy turn into a recession similar to what we experienced in the early 1980s or 1990s.

WILL CONSUMPTION KEEP UP?

The last two genuine recessions in Québec saw consumer spending drop sharply, with several elements contributing to this decline (graph 2). Interest rates were high, job losses mounted over a period of several consecutive months and the unemployment rate shot up to way over 10%. Consumer confidence tumbled which lead to a major drop in consumer spending. And since consumption accounts for about 60% of Québec's GDP, a recession could not be avoided. The most recent statistics available for retail sales are for September, which showed a monthly gain of 2.3%. The end of 2008 will most likely prove to be a difficult period, as will the first half of 2009. The conditions are not in place for a drop in consumer spending like we saw during the last two recessions. Given the turmoil of today's economic environment, household confidence could play a decisive role.

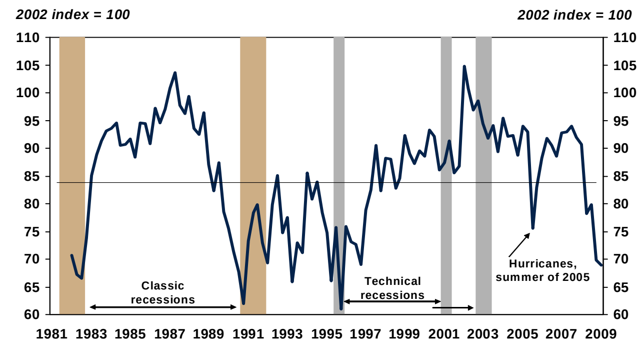
Graph 2 – Slowdown in consumer spending won't be enough to trigger classic recession



Sources: Institut de la statistique du Québec and Desjardins, Economic Studies

The deepening of the international financial crisis in October, which provoked a meltdown in stock markets amid extreme volatility, had a devastating effect on household confidence which plunged to near recessionary levels (graph 3). If stock markets take longer to stabilize, or if other major losses are recorded, consumer spending could be affected more than expected. Our scenario calls for growth of about 1.5% in spending on goods and services in the last quarter of 2008 and the first quarter of 2009, about half of the growth posted during the first half of the year. If confidence remains at the current low level, a drop in consumption is possible, and Québec's economy could fall into a genuine recession. Luckily, the labour market has yet to show any signs of worrisome deterioration and interest rates remain very weak, from a historical standpoint. It remains to be seen how a drop in consumer confidence could worsen the situation.

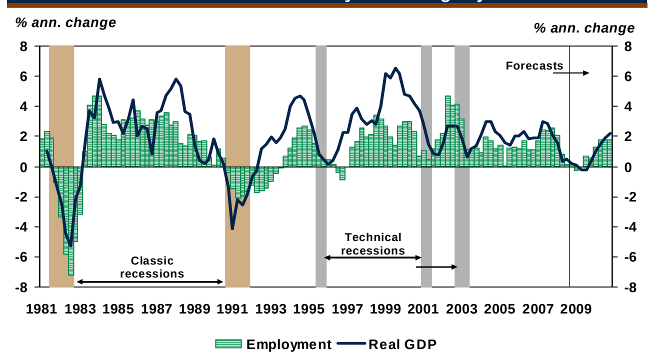
Graph 3 – Financial crisis plunging consumer confidence close to low points reached in the 1990s



Sources: Conference Board of Canada and Desjardins, Economic Studies

Despite the darkening economic climate, up to now the labour market has been holding its own (graph 4). Monthly employment figures have shown successive gains and losses since the beginning of the year, which shows that the labour market is somewhat fragile. And since employment usually fluctuates and is out of sync with economic activity, a decline

Graph 4 – Employment will fare better than during genuine recessions: stability to fall slightly

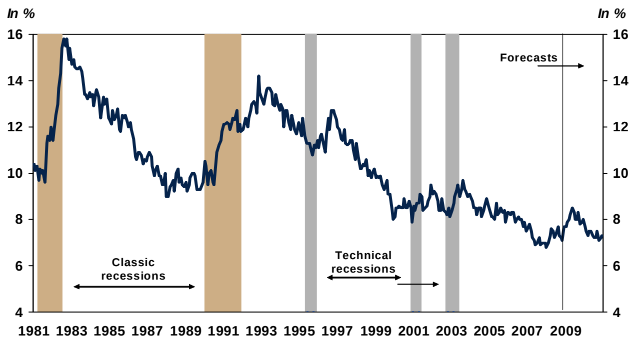


Sources: Statistics Canada and Desjardins, Economic Studies

is expected in the months to come. The recent slump in Québec's economy is still not enough to lead to the mass layoffs we saw during the last two recessions. However, job losses are still expected by the end of 2008 and in early 2009. The unemployment rate should therefore rise again to about 8.5% by mid-2009. This level has nothing to do with the peak reached during the last two classic recessions (15.8% in August 1982 and 14.2% in November 1991). This time, however, the labour shortage that is affecting many sectors will help contain the rising unemployment rate.

It bears noting that the 7.1% unemployment rate in November 2008 is still close to the low point of 6.8% reached in early 2008 (graph 5). The labour market remains far from the deep deterioration currently taking place in the U.S. If Québec sustains major job losses in the months to come, consumption will face greater risks.

Graph 5 – Unemployment rate will increase as it did during previous technical recessions



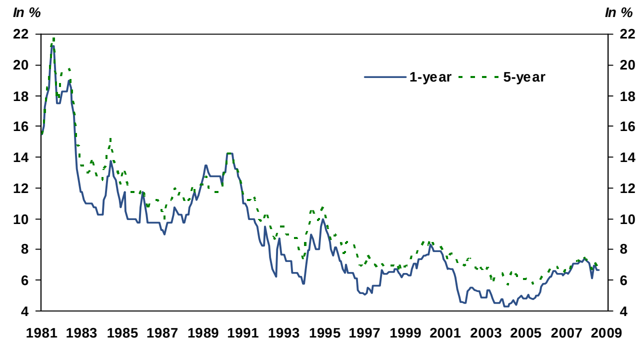
Sources: Statistics Canada and Desjardins, Economic Studies

OIL AND INTEREST RATES HAVE A POSITIVE IMPACT

Two factors will help consumers through this period of turbulence. First of all, the drop in oil prices–to approximately US$45 a barrel after soaring to close to US$150 a barrel in July–is now being felt at the pump. Gas prices have fallen to around $0.75 a litre in Québec. The persistent risks of a global recession will contribute to containing and even cutting energy prices in the coming months, providing households with some welcome breathing room.

The gloomier economic outlook and the pressing need to restore confidence in the international financial system will compel the major central banks, especially the Bank of Canada, to cut their key interest rates once again. The retail rates in effect for individuals will probably not fall as much due to the financial crisis. As such, consumers appear to be shielded from sudden increases in interest rates, like during the last two classic recessions. Back then, the fight against inflation and public deficits saw interest rates shoot up to levels that households simply could not handle (graph 6). The Bank of Canada has introduced policies to control inflation since then and the sound management of public finances will help prevent a similar shock from recurring.

Graph 6 – Mortgage rates will not bring down the real estate market

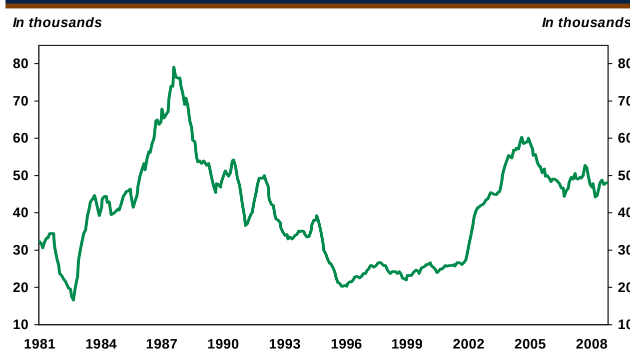


Sources: Statistics Canada and Desjardins, Economic Studies

HOW LONG CAN THE HOUSING MARKET CONTINUE TO RESIST HEADWINDS?

Until now, Québec's housing market has been running smoothly. The slight decline in housing starts since the start of the year has allayed concerns of any meltdown similar to what we are seeing in the United States. The current level of activity is nothing like the slump we saw in the 1990s (graph 7) and it is unlikely that such a situation will occur. The strength of construction from 2000 to today was not excessive given that the housing shortage had to be addressed. Instead of reducing the pace of construction, the less favourable economic conditions have seen demand shift to less expensive products like semi-detached houses and condominiums.

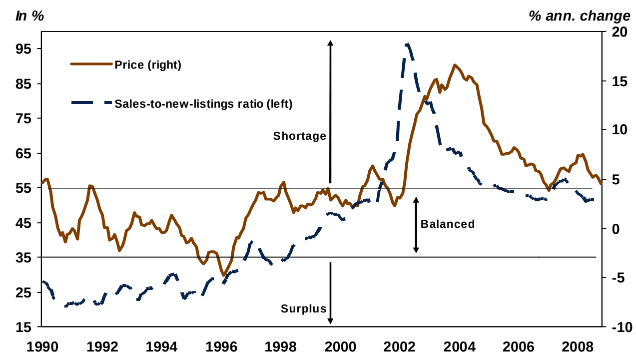
Graph 7 – Housing starts trending downward slightly



Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

Up to now, sales of existing homes have not shown any noteworthy declines. However, price increases are gradually fading away. While price increases for 2008 overall will be about 4.5%, the year-over-year changes were nil in October. Any significant and lasting price declines–usually associated with a surplus, like in the 1990s–are unlikely in the short term (graph 8). In the more expensive neighbourhoods of Montréal, especially in TMR (Town of Mont Royal), Westmount and Outremont, home prices have started to level off above $700,000. Demand is slowing down significantly in the high-end segment, which is more vulnerable to price declines.

Graph 8 – Surplus real estate dragged down prices in the 1990s



Sources: The Canadian Real Estate Association and Desjardins, Economic Studies

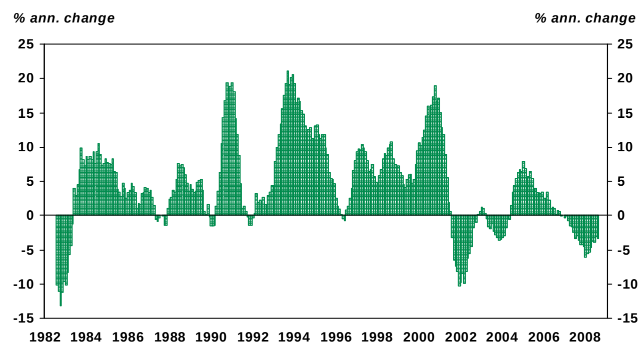
Only a major deterioration of the labour market, a more severe tightening of credit conditions or a sudden spike in interest rates (highly unlikely) would see Québec's housing market fail. Vigilance is in order, but there's no reason to sound the alarm just yet. Stricter rules for mortgage loan insurance that came into effect on October 15 could slow demand, however. The game is not over yet, but the residential sector is not fully immune from the repercussions of this financial turmoil.

Businesses are already feeling the impact of tightened credit conditions. Higher borrowing costs–due to risk premiums required by financial markets–are delaying some investment projects, especially those involving non-residential real estate. The prevailing climate of uncertainty will see some projects shelved altogether, especially if financing is required. The amounts invested by companies that recorded good growth these past few years will be somewhat mitigated until the effects of this financial crisis start to dissipate. We will probably have to wait until 2010 before we see any real rebound in business investment.

EXPORTS ARE ALREADY SUFFERING

The troubles in the U.S economy have affected exports since the start of 2007 and the decline is broad enough to be tied to a recession (graph 9). Other than the economic conditions, which are affecting Québec's exports, several structural changes have disrupted foreign trade since the start of this decade. The loonie's rise, which was valued at under US$0.65 in 2001 and the growing penetration of Asian products in North America have considerably reduced the market potential for Québec's exporters. These changes also favoured a sharp increase in imports to Québec. As a result, the trade deficit reached a record level of more than $25 billion (in real terms), a sharp contrast with the surplus seen at the start of the decade. This is the weak link that singles out this cycle in Québec's economy, a situation that will lead to a mild recession this time.

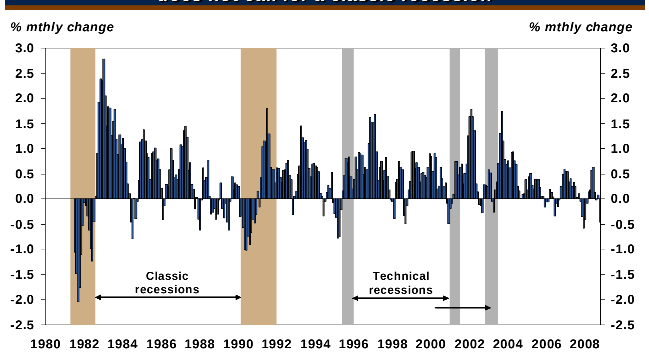
Graph 9 – Decline in international exports is fairly steep



Sources: Institut de la statistique du Québec and Desjardins, Economic Studies

It is sometimes difficult to get an overall snapshot of the economy simply by looking at individual statistics. The Desjardins Leading Index (DLI), made up of about 10 indicators that usually anticipate economic cycles, provides better insight (graph 10). For a recession similar to the ones we experienced in the early 1980s and 1990s to occur, the economic indicators would have to show a much deeper and much more widespread deterioration. Recent shifts in the DLI show that this is unlikely, for the time being.

Graph 10 – The Desjardins Leading Index does not call for a classic recession



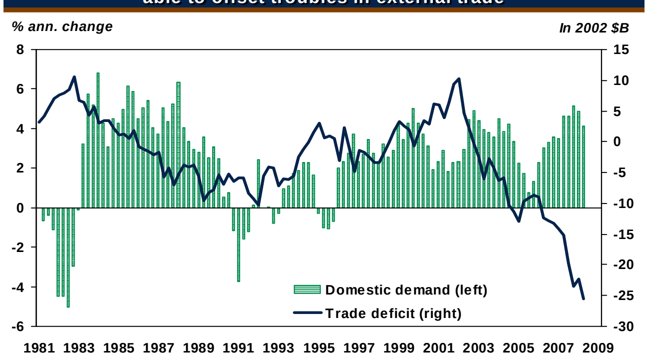
Source: Desjardins, Economic Studies

Table 1 – Strengths of Québec's economy
Labour market resistance (unemployment rate at 7.1% and jobs levelling off).
Almost $2B in federal and provincial tax cuts for individuals in 2008.
Weak interest and currency exchange rates as well as falling energy prices.
Housing starts remain high.
Québec's infrastructure plan: Investments of $7.6B in 2008-2009 and $8.3B in 2009-2010.
Hydro-Québec's investment to reach $4.5B in 2008 and $5.0B in 2009.
Industrial structure (several players in aeronautics, not very dependant on automobile sector).
Source: Desjardins, Economic Studies

Table 2 – Weaknesses of Québec's economy
Stock market meltdown has seen consumer confidence plunge close to low point seen during the last recession.
Real estate market not fully immune from falling prices.
Tightened credit conditions will halt business investment.
Trade deficit has hit a new record .
Recession in the U.S. will see falling exports decline further.
Plunging prices for raw materials will affect resource-rich regions, especially mining.
Source : Desjardins, Études économiques

In short, few of the statistics analyzed in this economic viewpoint are in line with the onset of a steep recession. The period of contraction will be more in keeping with a technical recession, i.e. two consecutive quarters of slight real GDP contraction (less than 1%). The situation will be nothing like the genuine recessions we experienced at the beginning of the 1980s and 1990s. Apart from consumer confidence and exports, the overall economic environment is clearly more favourable today than it was then. Unless the labour market deteriorates significantly, dragging down consumer spending and the real estate market with it, domestic demand will remain in positive territory this time around (graph 11). However, this will be insufficient to offset the growing trade deficit—a situation that will weaken real GDP. Our forecast scenario calls for real GDP growth of 0.7% this year and for greater stability next year.

Graph 11 – Strong domestic economy is no longer able to offset troubles in external trade



Sources: Institut de la statistique du Québec and Desjardins, Economic Studies

Unfavourable factors are nevertheless everywhere and uncertainty abounds. The downward trend of Québec's exports could very well sharpen in the coming months. The tightening of credit conditions–attributable to the financial crisis–should halt corporate investment. Lastly, the stock market meltdown, which has undermined the good mood in households, could throw cold water on consumer spending, which accounts for about 60% of Québec's GDP.

However, some measures put forth by both governments will help cushion the blow. Provincial tax rebates to the tune of $950M and federal rebates of $900M for Québec households in 2008 were just right for consumers. Weak interest rates and falling energy prices were another plus. Québec's plan to rebuild its infrastructures, with investments of $7.6B in 2008-2009 and $8.3B in 2009-2010, will limit any damage to economic growth. The federal government is also planning to inject vast sums in Québec's infrastructures. In total, governments plan to invest $12.5B in Québec in 2009, the greatest single contribution to the GDP since 1977. In spite of this support, Québec will be unable to stave off a technical, i.e. mild, recession. The deterioration of Québec's economy and the labour market will be much less severe than in the United States, which is in the grips of a classic recession.

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