

## The probability of a recession is high, especially in the United States

### IS THERE DANGER IN THE WINGS?

The U.S. economy is still shaken by the explosion of the mortgage credit and liquidity crisis last summer. Major upheaval has hit financial markets worldwide, with repercussions for the real economy. The economic slowdown is now very much with us, as the latest economic statistics confirm. However, this state of affairs was foreseeable, and was an integral part of our economic scenario. U.S. economic growth, hard hit by the American housing market tumble, went from 2.9% in 2006 to 2.2% in 2007, and reached a low point in 2008, at 2.0%.

Canada is surviving this turbulent period with more serenity; real GDP growth has slowed slightly from 2.6% in 2007 to 2.4% in 2008. It is primarily foreign trade that is being hurt by the strong loonie, and the American slowdown will magnify this poor performance, especially in manufacturing. The provinces east of Manitoba will be the most affected. In western Canada, the energy sector is supporting strong growth. The tax cuts that have gone into effect at the beginning of 2008 will also encourage consumption, while the real estate sector is still sound.

Both American and Canadian monetary authorities are being very vigilant, making loud and clear statements about their firm intentions of responding promptly to the slightest sign of greater economic weakness. Already, our economic scenario contains three additional cuts to the federal funds rates in the United States, and two further cuts for Canadian key rates. However, if the economy begins a more serious skid, rates could easily be cut more deeply.

### SERIOUS SHORT-TERM RISKS

Clearly, the short-term risks of a rapid deterioration by the U.S. situation are very serious. Any bad news from the financial services sector or U.S. mortgage lenders could touch off another crisis in the financial markets, making credit conditions tighter and even more suffocating. The collateral impacts on consumption and business investment could then be substantial enough to cause these two major components of the economy to contract. A stock market tumble would also have negative consequences for household balance sheets, and sap their confidence. A strong surge by oil prices above US\$100 a barrel could also lead to a stronger-than-forecast contraction by the American economy. In Canada, the danger will primarily come from the south, via foreign trade. However, we must not overlook the strains on the financial markets, even though they have resolved somewhat lately.

### Real GDP growth and probabilities of recession

	Real GDP growth in %			Probabilities of recession in %
	2006	2007f	2008f	2008
United States	2.9	2.2	2.0	40
Canada	2.8	2.6	2.4	15
Québec	1.7	2.3	1.6	25
Ontario	2.1	2.1	1.8	25

Source: Desjardins, Economic Studies

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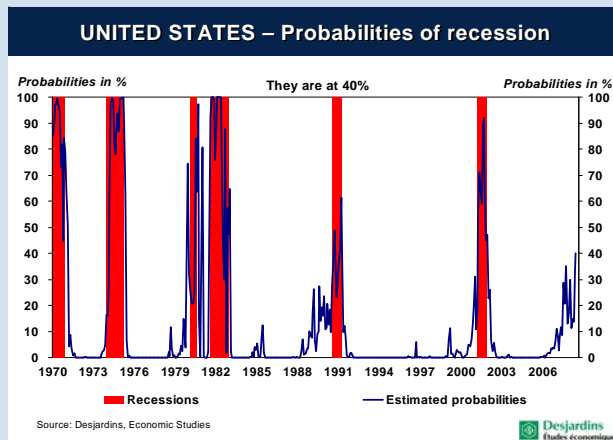
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**AN AMERICAN RECESSION IS MORE LIKELY BUT STILL AVOIDABLE**

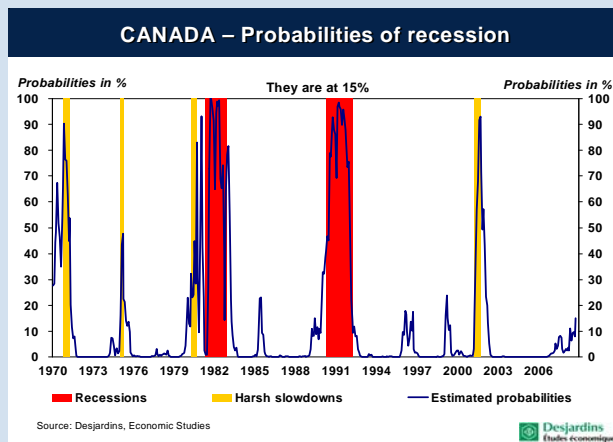
The risks of a recession in the United States are high, and the main destabilizing factors are still associated with the housing market and the struggles in mortgage credit. The onset of the New Year has, however, brought its own share of bad news with it. The likelihood of a recession is still around 40%, without being inevitable. Aggravating factors include the pullback by the ISM manufacturing index, showing that activity in the manufacturing sector will shrink. The second factor is the poor performance by employment. The private sector lost 13,000 jobs in December in the United States. The jobless rate has also climbed 0.6% from its low point last March, going to 5.0%. This type of increase often signals that the situation has deteriorated sharply. The third factor is the weakness of the stock market indexes. From the peak reached early last fall, the S&P500 is down by around 10%. Lastly, the increase in oil prices is increasingly eating into households' real incomes. The combination of these factors, if they deteriorate further, could limit U.S. economic growth and take it to the brink of a recession. Luckily, some other factors support growth, such as the strong international economy, decline by the U.S. dollar and drop in interest rates. If there is more substantial deterioration by the economy, government and monetary authorities will surely respond with more expansionist policies.



**CANADA IS MORE RESISTANT THAN EVER TO THE CURRENT TURBULENCE**

As a major oil exporter, Canada has an undeniable advantage. Western Canada is benefiting from this wealth which, for example, translates into a growth forecast of 4% for Alberta in 2008. For now, there are few signs that the Canadian economy is losing steam. Employment growth is solid, as is consumer spending, and the real estate market is holding up.

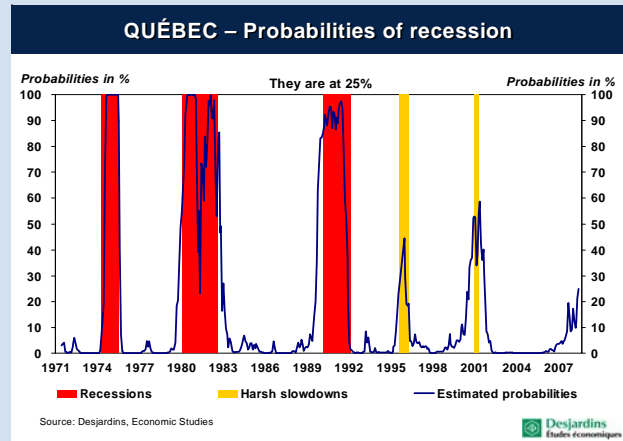
A Canadian recession could occur via foreign trade, which is being hard hit by the loonie's strength against the greenback. The impact, already sorely felt in the mounting job losses in Canada's manufacturing sector, will continue throughout 2008. If the American economy slips into a recession, the situation would be even more dangerous, and could take Canada into a recession as well. More stringent tightening of credit conditions could also have repercussions for consumption and business investment. However, the risks of a recession are relatively low, at about 15% for Canada. The country also has internal stimuli like tax cuts and substantial public investment in infrastructure (Québec's infrastructure program, Winter Olympics in British Columbia, etc.). Also, at least two more key rate cuts are expected at the beginning of 2008, which will help the economy make an easier transition through the turbulence. The Canadian government also has some financial leeway that it could use, in the event of a real need.



### THE RECESSION RISK IS MODERATE IN QUÉBEC

The context for Québec's economy has dimmed somewhat. With the risk of a recession in the United States high, 2008 will be even harder for exporters to get through. The last time the American economy contracted, in 2001, Québec's exports there dropped off abruptly. With our dollar much stronger than it was then, there is a real risk of greater deterioration than forecast. Québec's recession risk is thus about 25%.

A recession should be avoided, however, thanks to the strong domestic economy, which has several pillars. First, the five-year plan tabled by the Québec government to restore infrastructures will stimulate economic growth. The injection of 30 billion dollars over five years will, on its own, increase real GDP growth by about one quarter of a percentage point a year from now until 2012. For consumption, the federal and provincial tax cuts, as well as January's GST cut, will support spending this year. Note that, below 7% last fall, the unemployment rate is at a low that dates back to 1974. All of these factors are helping to keep consumer confidence strong. However, keep an eye on how much consumer sentiment is affected by soaring oil prices at close to US\$100/barrel. All in all, real GDP growth will fall off to 1.6% in 2008, after being just over 2% last year.



### ONTARIO'S MANUFACTURING SECTOR IS ALSO IN DISTRESS

Ontario's economy should not see a recession this year, but we are forced to conclude that the risks are substantially higher for this province which, unlike the rest of Canada, is being negatively impacted by skyrocketing commodities prices. The situation has worsened lately, and the likelihood of a recession in Ontario now stands at 25%. If the United States were to go into a major recession, it would become hard for Ontario's economy to avoid a downturn.

Of particular concern is the health of Ontario's important manufacturing sector. This sector (which is already grappling with major structural changes due to the loonie's surge, intensification of international competition and the automotive sector's restructuring) will now have to deal with a fairly steep slowdown in American demand. Ontario manufacturing employment should thus continue to pull back this year, while foreign trade's evolution will keep reining in economic growth.

The strength of domestic demand will, however, help to avoid a recession. Employment and wage growth over the last few months will buoy consumer spending, and the McGuinty government has the financial manoeuvring room it needs to help Ontario's economy get through this difficult period. What's more, a gradual, orderly slowdown in the housing sector began a few years ago, which reduces the risks of a violent correction like the one that hit the United States. Ontario should post growth of 1.8% in 2008, down from the 2.1% recorded in 2007.

