Economic Viewpoint

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The strength of the labour market in Canada could still surprise

Despite weaker economic growth in the last few months, Canada's job market has surprised forecasters since last fall with growth that is well above the consensus forecast. This *Economic Viewpoint* will show that the current divergence between strong domestic demand and deteriorating foreign trade is creating two separate trends in Canada's job market. On one hand, manufacturing jobs are dwindling due to the recession that is underway in this sector of activity. On the other, employment is growing in the service sector, under the impact of growth in domestic demand. As the outlook for domestic demand remains fairly good, everything suggests that, overall, the job market will be able to continue to rise, despite the major slowdown by real GDP.

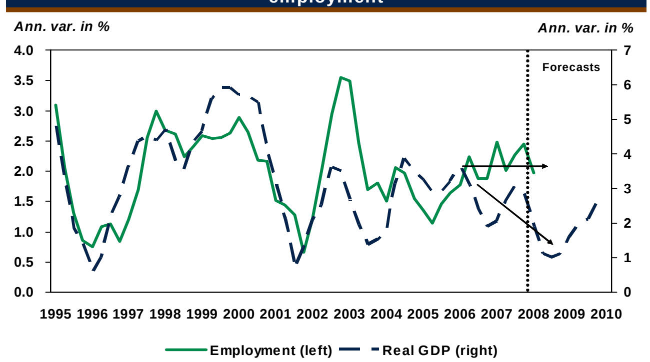
EMPLOYMENT'S RESULTS ARE SURPRISING

Canada's job market confounded most analysts' predictions in the last few months, with growth by employment above the consensus forecast in most cases. The mean deviation between the consensus forecast of analysts surveyed by Bloomberg and actual job creation as disclosed by Statistics Canada stands at 34,600 jobs since September. This underestimation of job creation is sizeable in a context in which the average monthly gain for the whole of 2007 is 29,842, a level that is below the forecasting error.

Forecasters' pessimism comes from the recent deterioration in economic conditions in Canada. The adverse impact of the loonie's appreciation has lately combined with the U.S. economy's more pronounced slowdown to intensify the deterioration by Canada's foreign trade. As Canada's economy is very open and trade with the rest of the world (especially the United States) has an important share of production, economic growth has slowed substantially in the last few months. After climbing by 3.6% on average during the first nine months of 2007, real GDP growth was only 0.8% in the final quarter of the year. These problems are still with us in early 2008, while the state recession that is affecting the U.S. economy could magnify Canadian foreign trade's deterioration. As a result, the economic slowdown here will likely continue in the quarters to come.

The usual relationship indicates that decline by real GDP growth normally comes with slower growth by employment. Moreover, one of the consequences of a pullback by real GDP or a technical[1] recession is usually the loss of many jobs and an increase in the jobless rate. In this context, it is no surprise that many analysts have been forecasting slower growth by employment for the last few months. This outlook has not yet materialized, however, and, on average, employment growth has maintained a fairly fast pace since last fall (Graph 1).

Graph 1 – The slowdown by economic growth still has not hurt employment



Sources: Statistics Canada and Desjardins, Economic Studies

[1] A technical recession is two consecutive quarters of contracting real GDP.

François Dupuis
Vice-President and Chief Economist

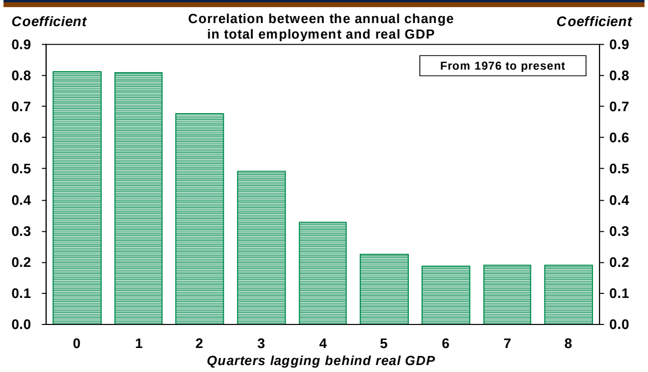
Yves St-Maurice
Director and Deputy Chief Economist

Benoit P. Durocher
Senior Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

Employment is often seen as a lagging economic indicator, so we could think that a job market slowdown is only a matter of time. But is that really so? As graph 2 shows, the correlation between the annual variation in real GDP and annual variation by employment is higher in the first three months following real GDP growth (with zero or one period lagging). These results show that fluctuations in the labour market lag very little behind fluctuations in economic growth. Moreover, non-farm employment is a component of the U.S. coincident index, which is a good illustration of this variable's close relationship with the economic cycle in real time.

Graph 2 – Employment is reacting more to the latest economic fluctuations



Sources: Statistics Canada and Desjardins, Economic Studies

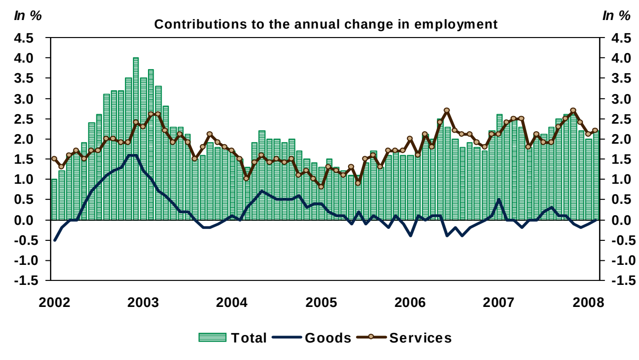
TWO SEPARATE TRENDS

In fact, the current divergence between the job market's vitality and the obvious slowing by real GDP growth probably stems from an increasingly clear duality in the economy. Economic growth is certainly being sharply hampered by foreign trade's deterioration, but domestic demand remains exceptionally strong. While the trade balance's decline led to a 6.4% decrease in real GDP in the fourth quarter of 2007, major domestic demand growth generated a 6.7% increase, the biggest contribution this component has made to economic growth in over 10 years.

It would be very surprising for domestic demand to maintain this frenetic pace. A number of factors still favour sustained growth by this component in the coming quarters. Consumer spending is lively, especially on durable goods and services. Note that the loonie's sharp appreciation since 2003 has reduced the prices of many imported goods, raising Canadian's buying power. Wage growth has also been higher than inflation for several months now. Canadians' disposable income has also been boosted by tax cuts from the federal government and some provinces, as well as from a decrease in the federal goods and services tax (GST). Business non-residential investment should continue to grow quickly, as the development of new production capacity in the natural resources sector (including energy) will need major investment. Some provinces, including Québec, have also initiated important public infrastructure investment programs, which will last for the next several years.

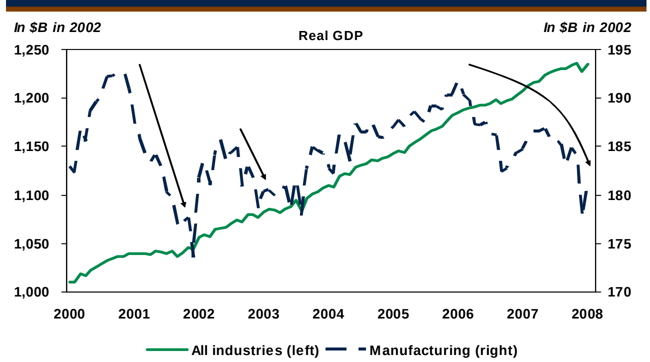
The divergence between domestic demand and foreign trade has major repercussions for the job market. In fact, almost all of the job growth seen in the last few months can be chalked up to the services sector (Graph 3), while employment in the goods sector has barely budged. Anaemic employment in goods production is mainly due to the problems in the manufacturing sector. The latter has been hard hit by the lost competitivity stemming from the loonie's sharp appreciation, as well as intensified competition from Asian nations and, more recently, the slowdown in U.S. demand. According to real GDP by industry, Canada's manufacturing sector is in a recession, and production has been declining since early 2006 (Graph 4). The losses incurred in manufacturing are, however, fully offset by gains in the other goods sectors, including construction, utilities, mining and energy. In the end, the goods sector as a whole has contributed very little to growth by total employment.

Graph 3 – Two separate trends in the job market



Sources: Statistics Canada and Desjardins, Economic Studies

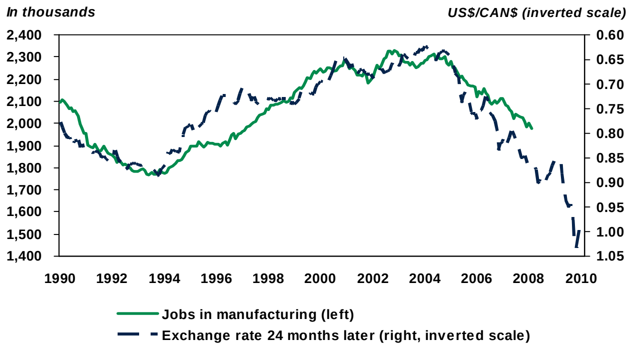
Graph 4 – The manufacturing sector is in a recession



Sources: Statistics Canada and Desjardins, Economic Studies

The close link between the problems in manufacturing employment and the loonie's appreciation is very clear in graph 5. In fact, it shows that the current evolution by manufacturing employment depends on the Canadian dollar's fluctuations 24 months earlier. The appreciation posted by the loonie in the last two years means that the manufacturing sector is likely to see further job losses between now and 2010.

Graph 5 – More job losses to come in manufacturing



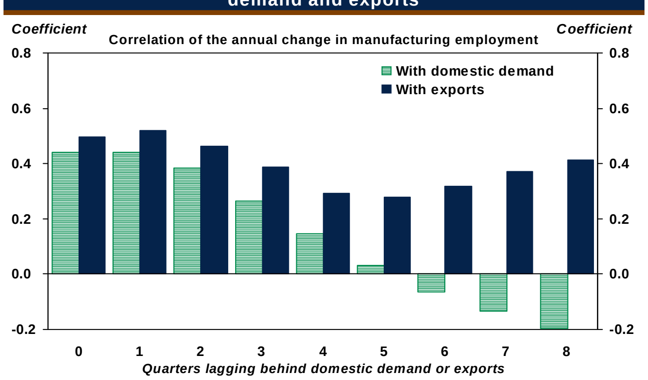
Sources: Statistics Canada and Desjardins, Economic Studies

The question now is whether Canada's job market will, in the next few months, still be able to hold up in the face of this kind of deterioration by manufacturing employment. To find out, it is clearly important to differentiate between the services and goods sectors in analyzing employment in Canada.

EMPLOYMENT IN MANUFACTURING IS MORE TIED TO EXPORTS THAN ARE JOBS IN SERVICES

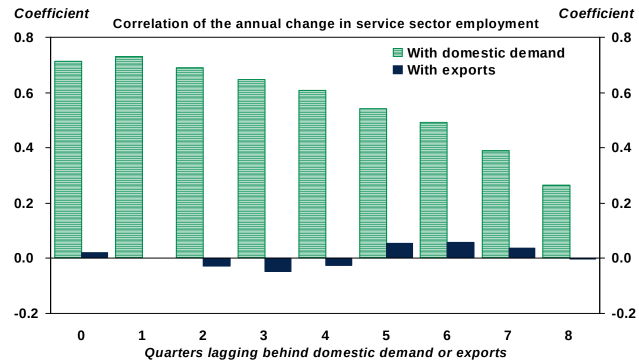
As graphs 6 to 9 show, employment's response to fluctuations in domestic demand and variations in goods and services exports is somewhat different from industry to industry. Unsurprisingly, the correlation between the annual change in manufacturing employment and annual change in domestic demand is almost the same over the near term as the correlation between the annual change in manufacturing employment and annual change in exports. This is because almost half of the manufacturing sector's output is exported, while the other half is sold on domestic markets.

Graph 6 – Employment in manufacturing depends on domestic demand and exports



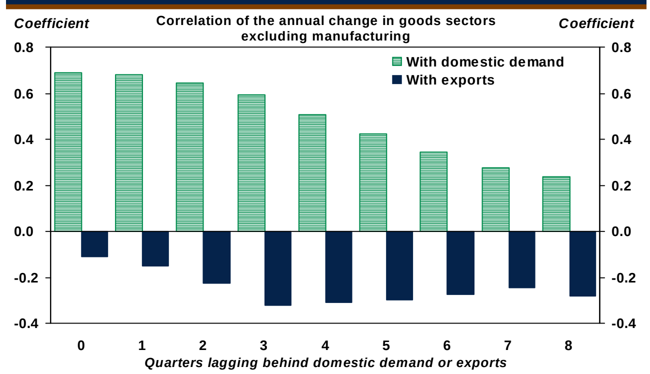
Sources: Statistics Canada and Desjardins, Economic Studies

Graph 7 – Employment in services is almost solely associated with fluctuations in domestic demand



Sources: Statistics Canada and Desjardins, Economic Studies

Graph 8 – Employment in other goods sectors is more dependent on domestic demand

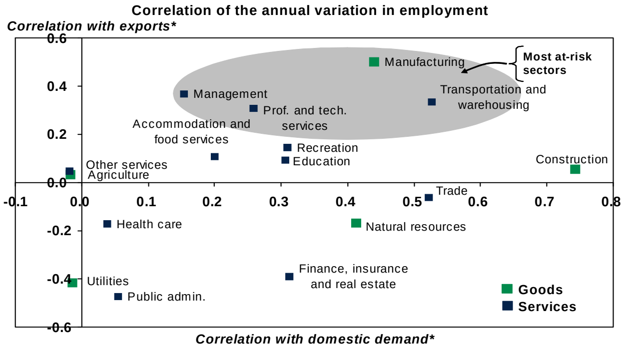


Sources: Statistics Canada and Desjardins, Economic Studies

The correlation of most other sectors with the fluctuations in exports is not nearly as high, however. This means that, as a whole, employment in the services sector shows almost no dependency on blips in exports. This contrasts with the correlation between employment in services and domestic demand, which is very high. Clearly, jobs in services are almost wholly dependent on fluctuations in domestic demand, and are barely influenced by exports. It should be noted that services only represented 15% of all Canadian exports in 2007, which is why these activity sectors are less sensitive to foreign trade. The fear that the problems in goods exports will potentially spread to employment in services seems to be ruled out, too, as we can conclude from the low correlation even several periods later. Lastly, employment in non-manufacturing goods sectors are also more dependent on fluctuations in domestic demand, and even show a slightly negative correlation with exports.

Aside from manufacturing, a detailed analysis of the various activity sectors shows that three other services sectors are particularly threatened, given their greater dependence on exports (Graph 9). The transportation and warehousing industry is very exposed due to fluctuations in the volume of merchandise shipped to other countries. The management and professional and technical services sectors are also at risk, as a substantial share of their services go abroad. However, of these four sectors, only manufacturing is actually grappling with a down trend.

Graph 9 – Dependence of sector employment on domestic demand and goods and services exports



* With no lagged variables.
Sources: Statistics Canada and Desjardins, Economic Studies

THE OUTLOOK IS STILL GOOD… ESPECIALLY IN SERVICES

As table 1 shows, manufacturing's share of the entire Canadian job market was only 12.1% in 2007. In contrast, the services sector accounted for almost 76% of all jobs. If we assume that domestic demand will remain dynamic in the quarters to come, it is likely that we will see further substantial gains in employment in services. Of course, the problems in exports will intensify manufacturing's losses. We even believe that almost 350,000 additional jobs could be lost in the next two years, an average of 175,000 jobs a year. But the gains in the other sectors should fully offset this decline. Note that, to date, the losses in manufacturing total 354,400 jobs since 2003. Meanwhile, the services sector has seen 1,505,200 jobs created, an annual average gain of about 286,700 jobs.

In the long run, not only should the jobs created in some goods sectors, such as mining, energy and construction, continue to go a long way to offset the losses incurred in manufacturing, but employment in services should continue to climb at a relatively rapid pace.

We can thus expect the Canadian job market to continue to grow in the coming quarters, even though there will likely be almost zero economic growth in the first half of 2008. This will help maintain a jobless rate that is relatively low, historically, and make for sustained wage growth. This virtuous circle will in turn fuel domestic demand which, as we have just noted, will help employment in services continue to climb.

Table 1
Canadian job market evolution

	Relative weight in 2007 (in %)	Job creation*			
		From 2003 to Mar. 2008 (in K)	In 2007 (in K)	In 2007 (in %)	First 3 months of 2008** (in %)
Goods-producing sector	**23.7**	**55.8**	**-42.7**	**-1.1**	**4.0**
. Agriculture	2.0	-8.9	-15.2	-4.4	12.9
. Natural resources	2.0	70.0	12.0	3.5	-16.0
. Utilities	0.8	21.4	16.2	13.0	31.9
. Construction	6.7	327.7	73.9	6.8	18.3
. Manufacturing	12.1	-354.4	-129.6	-6.1	-3.1
Service-producing sector	**76.3**	**1,505.2**	**400.8**	**3.2**	**2.0**
. Trade	15.9	255.4	63.8	2.4	-1.4
. Transportation and warehousing	4.9	84.9	39.8	4.9	4.7
. Finance, insurance and real estate	6.3	175.2	-0.4	-0.0	3.8
. Professional and technical services	6.7	191.2	57.2	5.2	16.5
. Management	4.2	115.3	-8.2	-1.1	5.1
. Educational services	7.0	170.4	20.9	1.8	-1.8
. Health care	10.9	226.2	45.0	2.5	2.7
. Recreation	4.6	59.7	65.2	8.9	-18.5
. Accommodation and food services	6.3	52.7	8.6	0.8	1.6
. Other services	4.3	43.0	30.6	4.3	3.2
. Public administration	5.1	131.2	78.3	9.5	10.6

* From December to December; ** At annualized ryhtme.
Source: Desjardins, Economic Studies

Finally, the year could end with job creation of about 300,000 jobs from December 2007 to December 2008, an average annual increase of 2.0% (vs. 2.3% in 2007). For next year, close to 330,000 jobs could be added, as the manufacturing sector's problems are likely to dwindle when the U.S. economy recovers. The average jobless rate should be in the neighbourhood of 5.9% in 2008 and 5.7% in 2009. These will be the lowest annual unemployment rates since 1974. This is a very positive conclusion for an economy which will see almost no growth in the next few months.

This is a very different dynamic than the one characterizing the U.S. job market, which has lost 232,000 jobs since this year began. True, the manufacturing sector is also struggling south of the border, but the problems there seem to be more profound. Many other activity sectors are recording substantial declines by employment, including construction, financial services and trade. Although employment's decline in the United States only totals 0.17% from last December's peak, the down trend that usually characterizes a recession seems to be well underway.

IMPLICATIONS FOR MORE THOUGHT

Canada's ongoing job growth in a context of a major slowdown in production will have substantial consequences for labour productivity. The impact will, of course, be different in the various activity sectors but, overall, we believe that the Canadian economy's productivity growth will decelerate and even decline in the next few quarters. We will look at this issue in greater depth in a future *Economic Viewpoint*.

Benoit P. Durocher
Senior Economist