ECONOMICS DIGEST
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Canadian current trends update...

- ▲ Real GDP was slightly weaker than expected in October.
- ▲ Employment in Canada returned to positive growth rising 17,500 in December.
- ▲ October retail sales rise 1.0% building on September's increase.
- ▲ The average pace of housing starts in the fourth quarter of 2011 was 199,200 units, compared to 204,600 in the third quarter.
- ▲ The improvement in the November trade balance is encouraging particularly as it resulted from a strong increase in exports.
- ▲ The headline inflation rate remained below the upper end of the Bank of Canada's 1% to 3% target band in November.

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Financial markets...

Gloom starting to lift

Upside economic surprises served to whet investor risk appetite in the early days of 2012 stoked by a spike in stronger than expected US reports. Even outside the US, the balance of reports fared better than market expectations except in the euro zone where the economy continues to weaken. RBC's economic surprise indices cover data for the US, euro zone, UK, Japan, Canada, and Australia. Importantly, the data confirmed a strengthening in the US labour market with 212,000 private-sector jobs created in December and the unemployment rate falling to its lowest level since February 2009. This improvement, abetted by reports of firming manufacturing and service-sector activity, supports our view that the rebound in growth over the second half of 2011 will be sustained through 2012.

In the first full week of trade, the world stock market gained almost a full percentage point and commodity prices, according to the CRB futures index, rose 2%. 10-year government bond yields bounced around although stayed within reach of their all-time lows. The prospect of central banks maintaining ultra-stimulative policy with prospective further easing in some countries will keep government bond yields low throughout 2012. In turn, low interest rates will support consumer and business investment with overall growth rates in all but the euro zone expected to be higher this year than in 2011. European growth will be held down by fiscal restraint although we expect the downturn to prove shallow and short lived. This is based on our assumption that policymakers make sufficient headway in resolving the debt crisis while keeping monetary policy stimulative enough to alleviate some of the attendant downward pressure on the economy.

Canada's economy caught its breath in the fourth quarter

Economic news for Canada proved more volatile than in the US recently. Labour data showed 55,000 jobs were lost in the final quarter of 2011 resulting in the unemployment rate rising to 7.5% from 7.1% in September. The softening in the labour market was consistent with the economy gearing down in October following four months of solid gains. October's flat print in real GDP was not enough to displace the strong growth recorded in prior months, and output was still 2.7% higher than in October 2010. Data for the final months of 2011 showed a mild pickup in activity driven by firm housing starts and sales, and rising auto production. We retain our call for Q4 GDP growth of 2.0% following the outsized 3.5% gain recorded in Q3.

Stronger US activity, low interest rates, and a gradual improvement in global financial markets will likely result in the average pace of growth recorded in the second half of 2011 being sustained in 2012. The Bank of Canada's *Business Outlook Survey* showed 37% of respondents expect business activity to increase, and although 41% anticipate slower sales growth, this follows a prolonged period of rapid gains. A growing number of firms indicated their intention to hire new workers with 21% more respondents planning to increase M&E investment than to reduce it. With business investment one of the mainstays of our 2012 growth forecast, the survey results strengthened our confidence that growth will sustained in early 2012.

Bank to remain on heightened alert

The Bank will stay focused on mitigating the effect of external events on the Canadian economy. This was the message in December when policymakers acknowledged that both the Canadian and US economies were outperforming their forecasts while putting equal emphasis on the downside risks to the outlook emanating from Europe via financial market turbulence and weakening trade flows. The less robust end to 2011 for Canada's economy means that the Bank will be on heightened alert as it assesses the effect of global events on the growth outlook. The prospect of the Fed holding the funds rate in the 0% to 0.25% range past the end of next year to ensure the economy stays on an accelerating growth path will allow the Bank to take its time in removing the 'considerable' monetary policy stimulus that is in place especially against a backdrop of stable domestic inflation. The reversal of fiscal support in 2012 and 2013 will provide additional incentive for the Bank to proceed slowly in withdrawing monetary policy stimulus. In keeping with the change to our Fed funds forecast, we reduced the amount of tightening that we expect by the Bank of Canada in 2012 and 2013. Our updated forecasts look for the overnight rate to end 2012 at 1.25% and 2013 at 2.0%.

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Special reports…

Canada's Finance Minister sets the rules on transfers to provinces beyond 2014

- Canada's Finance Minister Jim Flaherty announced his government's plan for future health and social transfers to the provinces.
- The current accord between the provinces and the federal government is set to expire in 2014.
- Finance Minister presented what is in effect a "take it or leave it" offer, which will eventually tie future health transfer increases to nominal GDP growth.
- The government also confirmed that other major transfers would continue to grow according to their current formulas.
- Federal transfers make up an important source of provincial revenues, at around 20% of total revenues over the past five years.
- If the pace of these transfers slows after 2016/17, it could have a noticeable impact on total revenue growth for the provinces.
- Given the aging of Canada's population, increasing health expenditures are likely to put further pressure on provincial budgets.

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Special reports…

Immigrant labour market outcomes in Canada: The benefits of addressing wage and employment gaps

- ▲ It is well recognized that immigrants to Canada have higher unemployment rates and lower wages than Canadian-born workers.
- ▲ This report provides an estimate of the size of the aggregate immigrant earnings gap, accounting for immigrants' stronger profile of observable characteristics, and discusses possible reasons for immigrants' poorer labour market outcomes.
- ▲ The research to this point suggests that gaps may be due to both genuine skill differences between immigrants and Canadian-born workers, and labour market inefficiencies that prevent immigrants from making full use of their skills.
- ▲ In either case, there could be room to improve on immigrant outcomes through more extensive language training, faster credential recognition, or other integration initiatives.
- ▲ More rigorous evaluation of existing programs would also be helpful in understanding why gaps persist and how we can best address them.

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