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Canadian Economic Observer

Year-end review of 2009

by Philip Cross

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. not available for any reference period
.. not available for a specific reference period
... not applicable
0 true zero or a value rounded to zero
0^s value rounded to 0 (zero) where there is a meaningful distinction between true zero and the value that was rounded
^{p} preliminary
^{r} revised
x suppressed to meet the confidentiality requirements of the *Statistics Act*
^{E} use with caution
F too unreliable to be published
* significantly different from reference category ($p < 0.05$)

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by Philip Cross [1]

Overview

While the 2008-2009 recession was rapid and closely synchronised around the world, it had a wide range of impacts on individual countries. In some countries, the severity and the length of the contraction earned it the moniker of "The Great Recession," a reference to some aspects of the downturn being the most severe since the Great Depression of the 1930s. For example, the 6% loss of jobs in the US in the last two years was markedly worse than US job losses in 1981-1982 and 1974-1975 (although the 3.8% drop in US GDP in 2008-2009 was comparable to these two recessions and equalled in the 1957 downturn). [2]

Canada, in contrast, experienced a recession that was less severe and shorter than in the other G7 nations. Between the third quarter of 2008 and the second quarter of 2009, real GDP in Canada fell by 3.6%. This compares with a total decline of 3.8% in the US during 2008-2009, and even larger declines in Europe and Japan. The drop in Canada's GDP that occurred over those three quarters also was shorter than the four to six quarters of contraction in the other G7 nations (Figure 3.1).

The milder recession in Canada was even more apparent in employment than in GDP, as jobs fell 1.8% between the third quarter of 2008 and the second quarter of 2009 (Figure 3.2). This is partly because more of the adjustment to labour inputs in Canada came from a shorter workweek than from employment.

Nor was the 2008-2009 recession in Canada unusually long or severe in comparison with the recessions of 1981-1982 or 1990-1992. The 3.6% three-quarter drop in real GDP in the latest downturn compared with 4.9% over six quarters in 1981-1982 and 3.4% over four quarters in the early 1990s. Quarterly jobs fell 5.0% in 1981-1982, 3.2% in 1990-1992 and 1.8% in 2008-2009. The more moderate recession in the labour market was reflected in the unemployment rate, which rose 2.5 percentage points to 8.7% in 2008-2009 versus increases of 4.2 points in 1990-1992 and 6.0 points in 1981-1982. In addition, the impact by industry closely resembled that of these earlier downturns.

One reason for the relatively mild slump is that Canada was better positioned to weather the global recession than other large western economies, primarily due to savings as reflected in our national balance sheet. Savings imbalances and asset prices played a large role in the global recession of 2008-2009, as opposed to imbalances in inventories or consumer prices, which had accounted for most post-war recessions.

Canada's GDP felt the impact of the global recession most directly in its international trade flows (Figure 3.3). Export earnings fell 22% in 2009, with the bulk of the decline occurring between the fourth quarter of 2008 and the first two quarters of 2009 (when exports tumbled 35% versus declines of about 10% at the worst of the two previous recessions). The drop reflected steep losses in both volumes (-14%) and prices (-9%). With exports falling rapidly, corporate profits plunged 33% in 2009. [3]

Firms responded to lower income by quickly cutting outlays: business investment fell a record 14% [4] in 2009, with over three-quarters of the drop accounted for by mining and manufacturing, which export most of their output. As well, firms cut inventories nearly $8 billion. Overall, firms slashed $41 billion from non-financial capital acquisition (Figure 3.4). This was over four times the $9.5 billion that firms cut from labour income paid to employees. Altogether, despite a $72 billion drop in profits in 2009, the net lending of corporations fell only $3 billion, to $51 billion, as a result of these cost-cutting measures.

Balance sheets and savings

Why was the recession less severe in Canada than in other countries, despite our large exposure to the global economy through exports earning and financial markets? A major factor in Canada's favour was the healthy state of its finances at the onset of the downturn. Corporations had used years of record financial surpluses to reduce debt-to-equity ratios to an all-time low. Large government and trade surpluses over the previous decade had significantly lowered both government and external debt and raised Canada's national saving rate. As a result, even with a personal saving rate brushing 2% (about the same as the US personal saving rate), Canada's national saving rate rose from 8% to 14% during the commodity boom (Figure 3.5). This reflected high saving rates in the government and corporate sectors. By comparison, the US national saving rate never reached 4% after 2001, and was below 1% when the recession began (and a negative 3% by its end). Governments in the US ran large deficits throughout the last decade, while personal saving were barely positive.

As the recession deepened, Canada reduced its national saving rate by 9 percentage points in just three quarters to sustain spending despite rapidly shrinking incomes. Much of the reversal in saving originated in the government sector, as the personal saving rate changed little. Corporate saving initially fell as profits plunged, but were quickly rebuilt as firms slashed spending.

One reason spending fell more rapidly in the US is that the flow of credit was impaired by dislocations in its financial system, ranging from the insolvency of several large financial institutions to the seizure of the commercial paper market in September 2008. In the US, Fannie Mae and Freddie Mac were put into conservatorship; Lehman Brothers was liquidated and all other investment banks were taken over or became commercial banks; the Washington Mutual and Wachovia banks failed and were taken over, while Citigroup and AIG needed significant US government support. Six of these eight major institutional changes occurred in September 2008. In Europe, 20 banks in 10 countries failed between July 2007 and February 2009. [5] European financial institutions requiring government support included Hypo Real Estate in Germany, Fortis and Dexia in Belgium and France, as well as the Royal Bank of Scotland and Bradford & Bingley in the UK. In Canada, no major financial institutions required government bail-outs.

Falling confidence in US financial institutions was reflected in a 10.3% decrease in borrowing by the financial sector in 2009, the first such decline on record. The drop in borrowing was particularly significant for investment banks, which rely on short-term credit for their funding (since, unlike commercial banks, they have no retail deposit base). [6] By contrast, financial institutions in Canada were able to increase their borrowing by 6%.

Overall, there was not a curtailment of credit in Canada between 2007 and 2009. Some markets were disrupted, notably the seizure in non-bank asset-backed commercial paper in August 2007. Loans by sales finance and other consumer loan companies fell in 2008-2009, but this was offset by more loans from chartered banks, and household credit overall kept growing. The federal government bought nearly $50 billion of mortgage securities from banks late in 2008 to strengthen the latter's balance sheet. However, these manifestations of the global credit crisis in Canada were relatively minor compared with the disruption in the US and other countries.

With the dislocations in its financial system, household borrowing in the US slowed steadily starting in 2007 and then turned negative by late in 2008 (Figure 3.6). With credit contracting and little cushion from savings, consumer spending in the US fell in 2008 and 2009, the first back-to-back declines since 1933. By contrast, in Canada, there was only a modest slowdown in household borrowing growth, from 10% in 2007 to 7% last year, and consumer spending rose in both 2008 and 2009, a major factor in moderating the recession.

The stability of household borrowing in Canada appears to reflect a number of factors. Household balance sheets in Canada were not ravaged like those in the US, as shown in Figure 3.7 on net worth. Net worth in the US fell 26.6% over nearly two years, while Canada's 8.7% drop was concentrated into three quarters. While the stock market was battered on both sides of the border, the longer and steeper slide of household wealth in the US originated in housing, a trend that began early in 2007. The supply of credit in Canada was not as impaired as in the US, and financing overall remained available for most households who wanted credit. This was most evident for mortgages, which financed the rebound in existing home sales that reached a record high by year-end. By contrast, mortgage credit in the US contracted in both 2008 and 2009, reflecting both weak demand for and supply of mortgage credit.

Household spending in Canada dipped in the fourth quarter of 2008, when housing investment fell 6.3% and personal expenditure declined 0.8%. Neither of these decreases can be fully explained by employment or disposable incomes, which remained steady in the fourth quarter. Instead, the retreat originated in the sudden drop in household wealth resulting from the global sell-off in stock markets. These declines were reflected in a sharp retreat in consumer confidence in the fourth quarter. Unlike the US, however, confidence quickly rebounded in Canada.

The monthly data on auto and house sales reflects the abrupt nature of their declines (Figure 3.8). Auto sales fell 20% in the two months to December 2008, while existing home sales dropped 34% between September and November 2008. These declines were reversed early in 2009, a reflection that it was the shock to confidence and not a disruption of credit channels that provoked their brief but sharp retreat late in 2008.

While household credit growth was little changed in Canada despite the recession, government debt rose sharply. In the four quarters after the recession began, borrowing by all levels of government rose by 21%, compared with little change for most of the previous decade (Figure 3.9). The increase reflected steady gains in current expenditure and an upturn in transfer payments and capital spending, while tax revenues fell sharply as corporate and personal incomes shrank.

Corporate borrowing also changed markedly during the recession. After rising by about 8% in 2007, the year-over-year growth of borrowing by non-financial private firms jumped 11% when the recession hit in the fourth quarter of 2008, a testament to how credit markets in Canada kept functioning at the worst of the crisis elsewhere. As the recession moderated, corporate borrowing also slowed, following a pattern similar to 1992-1993 and 2002. Borrowing needs also were reduced by a sharp increase of equity issues to $40 billion in 2009.

The stronger balance sheet of Canadian businesses entering the recession was reflected in fewer bankruptcies. The number of business bankruptcies fell in both 2008 and 2009, an unprecedented development during a recession. In 1982, business bankruptcies rose by 33%, while they rose 23% between 1990 and 1992. Even in the consumer sector, the 45% increase in bankruptcies was less than the near-doubling that occurred in 1990-1991 and 1981-1982.

When the global financial crisis first erupted in August 2007, Canadians bucked the global trend of investing in the safe haven of US government securities and instead repatriated funds to Canadian markets, enhancing the liquidity of the latter. This trend continued in 2008 as the global financial turmoil worsened, with the yield on some US government securities turning negative at the peak of the crisis. In 2009, global investors joined Canadians in investing more in Canadian assets. Non-residents in 2009 purchased a record $109.4 billion of Canadian securities, mostly bonds. Equity investment also rebounded to $26.2 billion in 2009 as Canada's stock market rallied.

Industry developments

The impact of the latest recession on output by industry in Canada was quite similar to that of the previous two recessions in 1981-1982 and the early 1990s. Manufacturing production accounted for just over half (51%) of the drop in total GDP between the third quarter of 2008 and the third quarter of 2009 (tentatively, the quarterly dates of the recession, although revisions may alter this). This contribution is slightly less than for 1981-1982 and 1990-1991, when manufacturers accounted for 68% and 58% respectively of production cuts (Figure 3.10 and Table 3.1).

Construction accounted for 12.7% of total output losses in the last recession, about equal to its average 14.8% contribution to the previous two downturns. Its share was slightly higher in 1990-1991, when the housing industry was adapting to the GST raising the price of housing. However, while the residential sector bore the brunt of construction losses in 1981-1982 and 1990-1991, declines in the most recent recession were almost evenly spread between the residential and non-residential sectors. This reflects steep cutbacks in engineering projects such as the oilsands.

With both construction and manufacturing leading the drop in output during recessions, it is not surprising that the goods-handling industries of wholesale trade and transportation posted the largest declines in the service sector. These two industries combined to account for 20% of the drop in output during 2008-2009, slightly below their average in the previous two recessions. As is usually the case in recessions, consumer-related services (retail trade and accommodation and food) posted small declines during the last recession, although less than in the previous two.

There were some unique industry developments during the 2008-2009 recession. Output fell quickly in the primary sector (notably mining), unlike in the previous two recessions, when this sector did not lower output until after the rest of the economy had begun to recover. The quicker response in the most recent recession reflects the sudden drop in both commodity prices and the exchange rate, which squeezed the profitability of firms in the resource sector (their operating profits fell 60% between the third quarter of 2008 and the second quarter of 2009). Business services [7] also saw demand contract in the latest recession, in contrast to the previous two recessions. While neither the drop in primary industries nor that in business services rivaled other goods in terms of their overall contribution to the recession, they bear close scrutiny in future cycles. Finance and government services [8] expanded during all three recessions.

While the broad pattern of industry output was similar to previous cycles, the cyclical downturn in 2009 was accompanied by profound structural changes in specific industries. The two most obvious examples were in the auto and forestry-related industries, which have seen wrenching declines in recent years. For autos, sales in the US began a steady decline in 2006 while import nameplates captured a growing share of vehicle sales in North America. Forestry was plagued by a litany of problems, ranging from the pine beetle infestation in BC to weak housing markets in the US to the ongoing shift from print-based media to the Internet.

Output losses in both these sectors accelerated rapidly when the recession further weakened demand. Overall, the auto and forestry-related industries (including forestry, lumber, printing and paper) ended the decade 56% and 36% below their peak in output in 2005 (Figure 3.11).

Auto assemblies in Canada peaked at 2.7 million units in 1999, and then began a slow but steady descent over the next decade to 2.1 million units in 2008. Falling sales in the US and bankruptcy proceedings for two major North American producers accelerated the decline to 1.5 million units in 2009, the lowest level in almost three decades. Export volume led the drop, down 62% between the fourth quarter of 2005 and the first quarter of 2009.

The mix of vehicles produced in Canada changed radically. Passenger cars, which were half of vehicles produced in 1997, comprised 84.4% of output in 2009 (and 98.5% in June 2009 after a truck plant closed in May). This reflects a steady drop in the production of trucks and mini-vans from 1.2 million in 1997 to just 0.2 million last year.

Forestry-related industries also saw their recent slide accelerate rapidly. Readers continued to migrate rapidly to Internet-based sources of information. As a result, the volume of newsprint exports fell by 37% from its peak late in 2004. In Canada, several dailies dropped one edition per week, while one national chain filed for bankruptcy. Lumber fared even worse, as export volume fell 54% in less than four years as a result of the collapse of US housing starts.

The drop in paper and magazine circulation caused widespread losses in output. Output in the printing industry shrank to less than $5 billion (in constant 2002 dollars), its lowest on record back to 1981. Paper manufacturing fell to $8.2 billion, a post-1982 low. Together with the drop in lumber demand, this sent forestry output to $3.5 billion, the lowest since records began in 1986, bringing the cumulative loss to 44% in just four years. While the $12.2 billion drop in motor vehicle output since 2005 has been widely-publicized, the $13.4 billion loss in forestry-related industries has had a larger impact on GDP over that period.

As the recession accelerated the long-term decline of some sectors, it confirmed increases in others. Before the global recession arrived, mining and construction were the fastest-growing industries between 2000 and 2006 in nominal terms, reflecting large price hikes for energy, minerals, and housing. After a setback during the recession, mining and construction have returned as the fastest-growing sectors of GDP since last summer (along with manufacturing). This reflects the quick recovery of commodity prices and housing in 2009.

In previous decades, recessions fully reversed the gains made by commodity prices during the boom phase of the business cycle, and the Bank of Canada commodity price index retreated to about 90 (1982-1990 = 100) on each occasion. However, commodity prices in the 2008-2009 recession bottomed out 50% above their previous troughs (Figure 3.12). The advance in prices was most evident for crude oil and metals, which began to recover in 2009 from a level already twice as high as they were in 2002.

The buoyancy of commodity prices was reflected in the stock market and the exchange rate. After plunging 40% late in 2008, the Toronto stock market in 2009 recouped three-quarters of its losses, led by a rally in metals and energy stocks. And after falling from parity to 80 cents (US) at the height of the crisis late in 2008, the Canadian dollar was close to parity again early in 2010. Large inflows of investment in bonds and stocks from abroad also boosted the exchange rate.

Conclusion

To the degree that the 2008-2009 global recession originated in balance sheets, strong balance sheets in Canada stood it in good stead to endure the recession and emerge into recovery. The recession was shorter and milder in Canada than in other G7 nations, partly because the flow of credit was not disrupted as it was in other nations and a large pool of savings was available to finance spending when income fell temporarily. This reflects both healthier balance sheets built up during the 2003-2008 commodity boom and the absence of problems in major financial institutions such as those seen in the US and Europe.

Notes

1. Chief Economic Analyst (613-951-9162)
2. Jobs fell 6.1% in 2008-2009, versus 2.8% in 1974-1975; 3.1% in 1981-1982; 1.4% in 1990-1991; and 1.8% in 2001-2002. The 14.8% drop in US industrial production in 2008-2009 exceeded the declines of 13.6% in 1957-1958, 13.0% in 1974-1975, and 9.3% in 1981-1982.
3. Imports fell sharply too, with all of the drop due to a 13% decline in volume as prices were steady. Nearly two-thirds of the drop in imports was concentrated in autos and machinery and equipment, sectors where exports have an import content of about 50%. The net result of exports falling faster than imports was a current account deficit of $41.3 billion, due largely to the first shortfall for trade in goods since 1975.
4. Business investment fell 17% in volume: the next largest on record back to 1961 was a 12% drop in 1982.
5. For a detailed description, see Henry Paulson Jr., "On the Brink: Inside the Race to Stop the Collapse of the Global Financial System." Business Plus (Hachette Book Group), NY, 2010, p. 318 to 322 and p. 436.
6. "…investment banks are financed literally overnight by others on the assumption that they will be around the next morning…", Andrew Sorkin, Too Big to Fail, Viking Press, 2009, p. 10.
7. Business services include professional, scientific and technical plus administrative services.
8. Government comprises public administration, health and education.

Chart 3.1
Change in real GDP from 2008 peak to trough

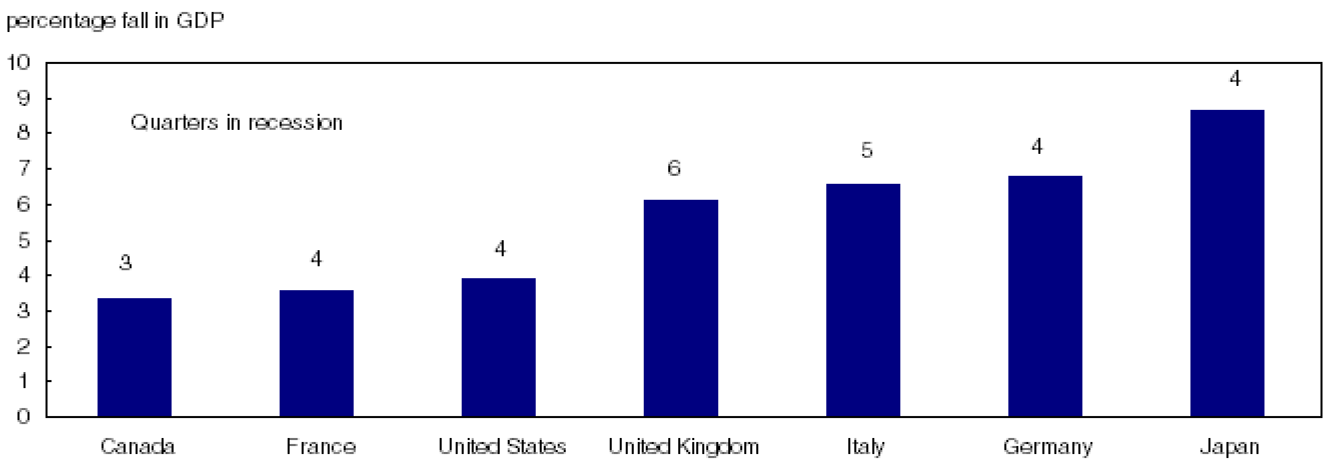


Chart 3.2
Employment

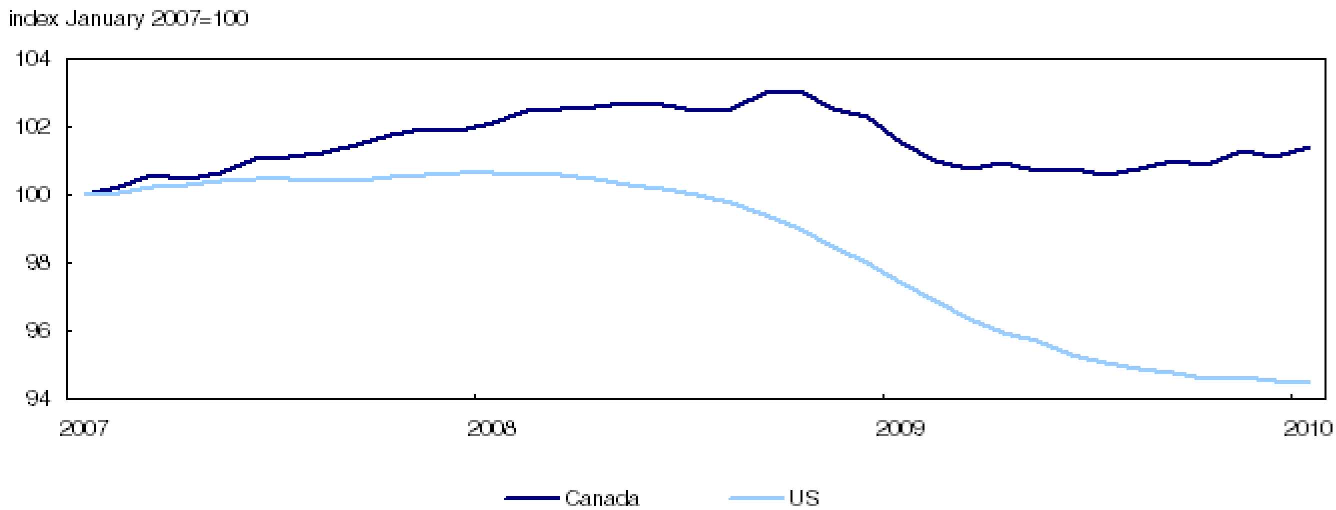


Chart 3.3
Merchandise exports in recent recessions

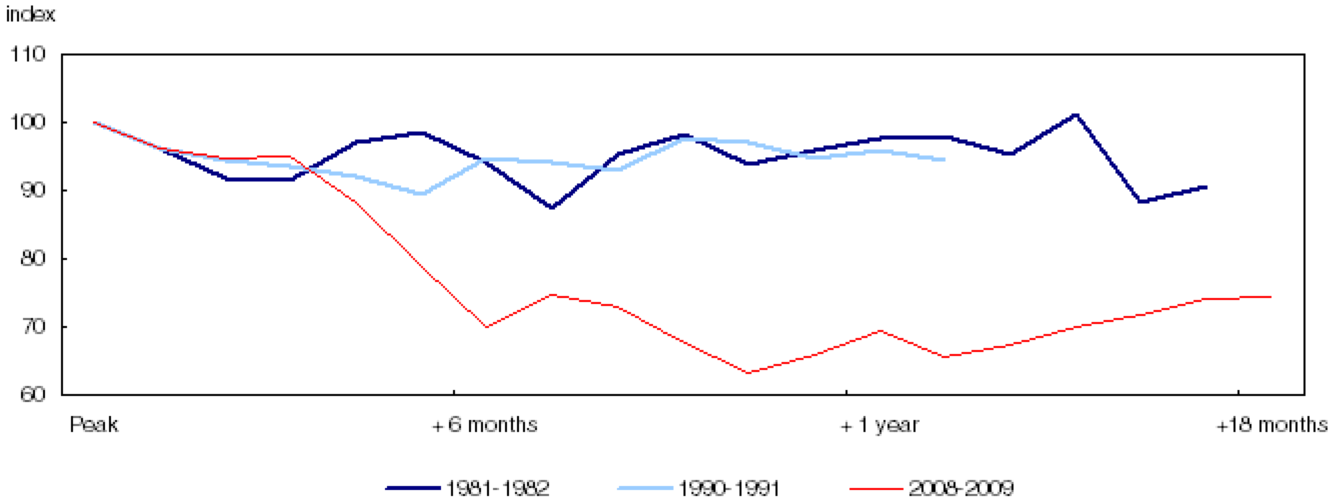
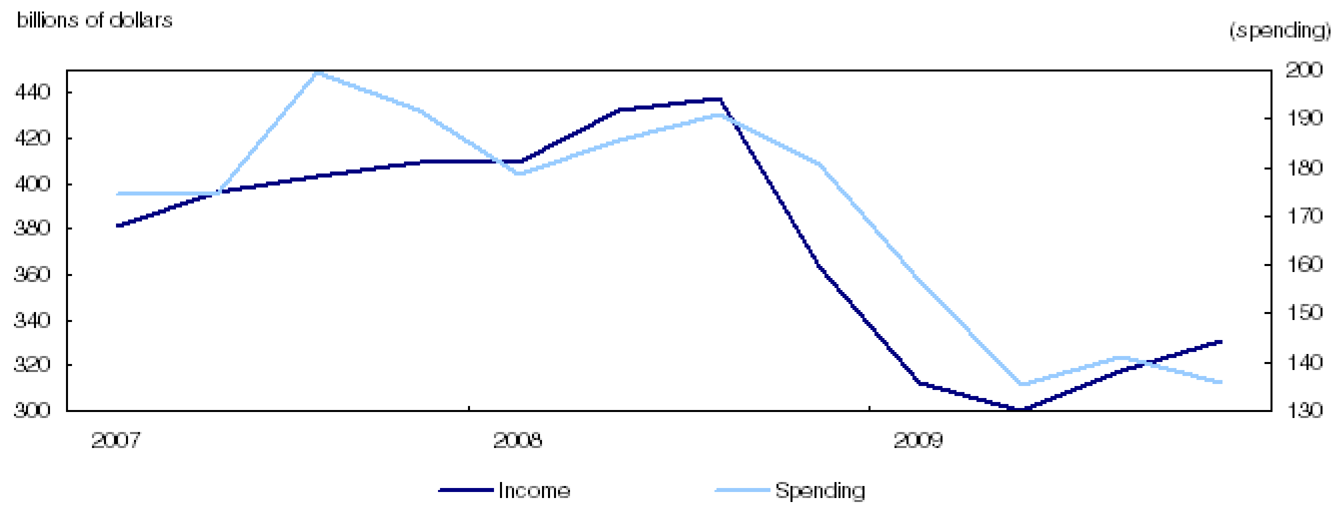
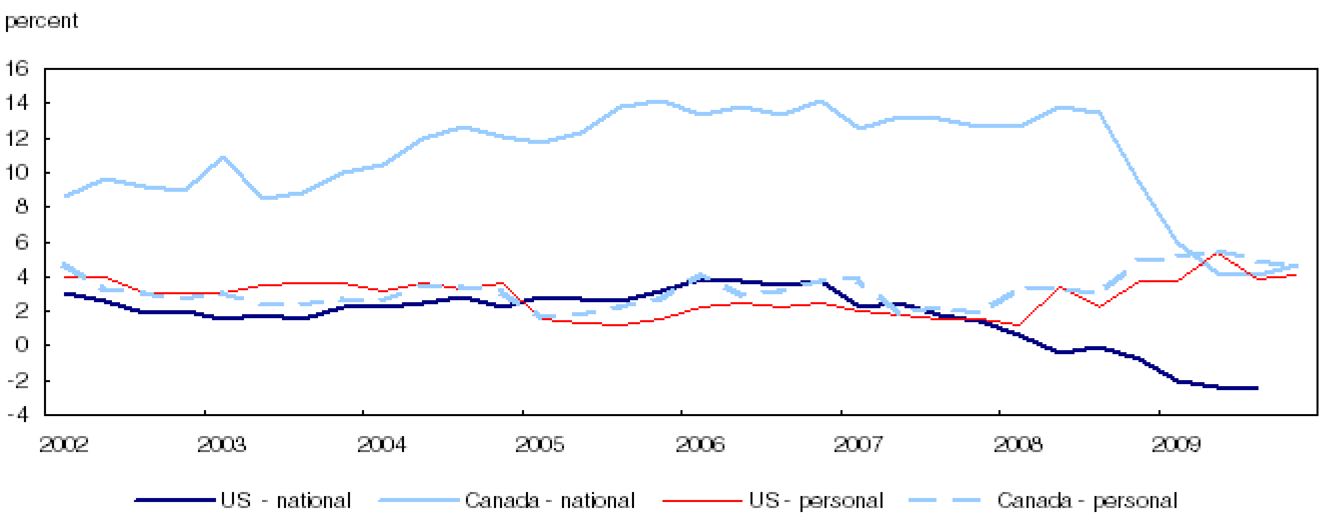


Chart 3.4
Corporate income and capital spending[1]



1. Income is from the Income and Outlay Account while spending is total non-financial capital acquisition.

Chart 3.5
Saving rates[1] - Canada and US



1. National saving is a percent of gross national income; personal saving is a percent of personal disposable incomes.

Chart 3.6
Total household borrowing and real personal expenditure

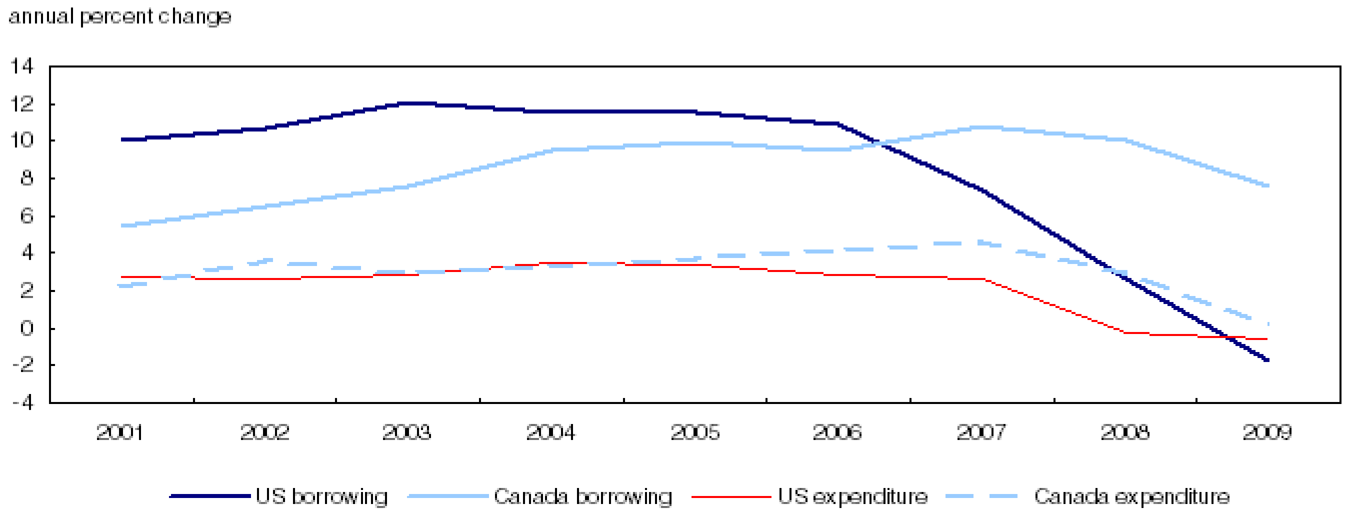
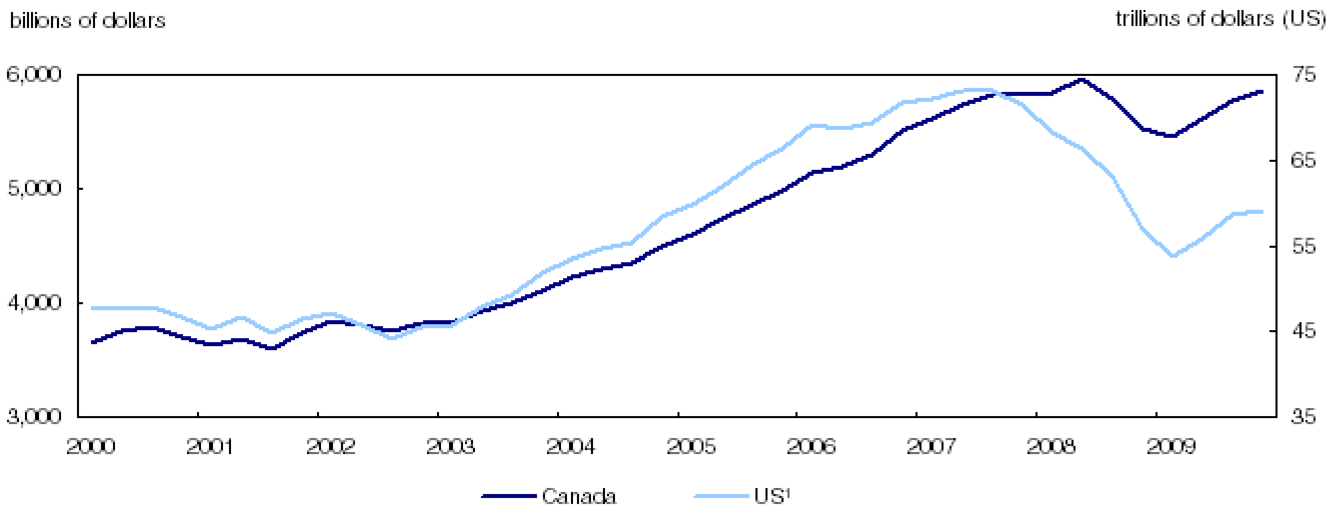


Chart 3.7
Household net worth



1. Adjusted to Canadian concepts.

Chart 3.8
Auto and house sales

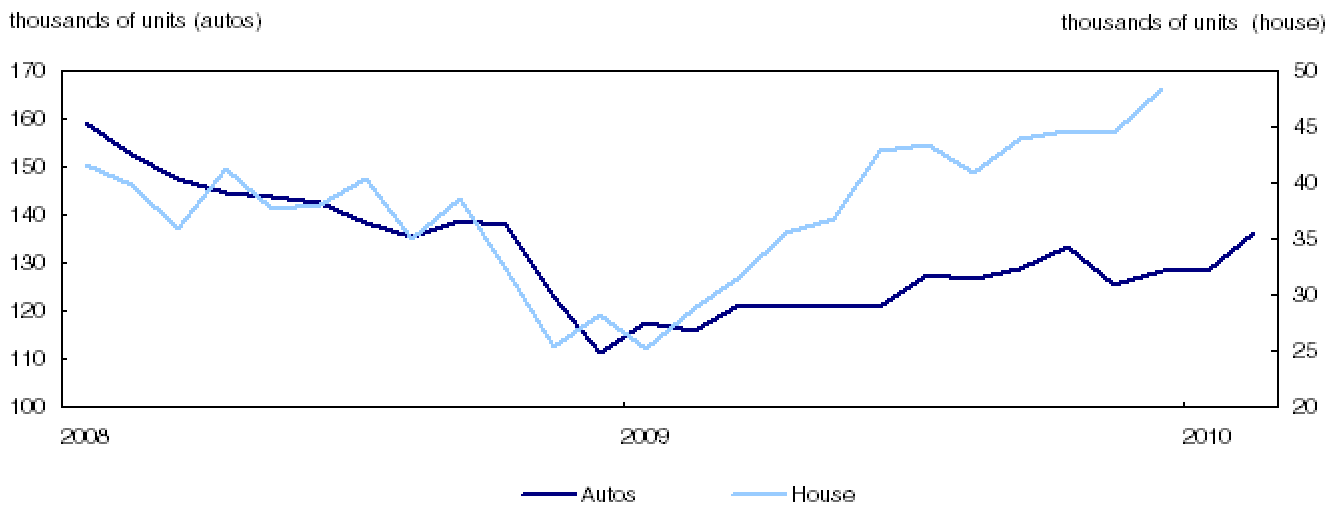


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Chart 3.9
Sectoral debt

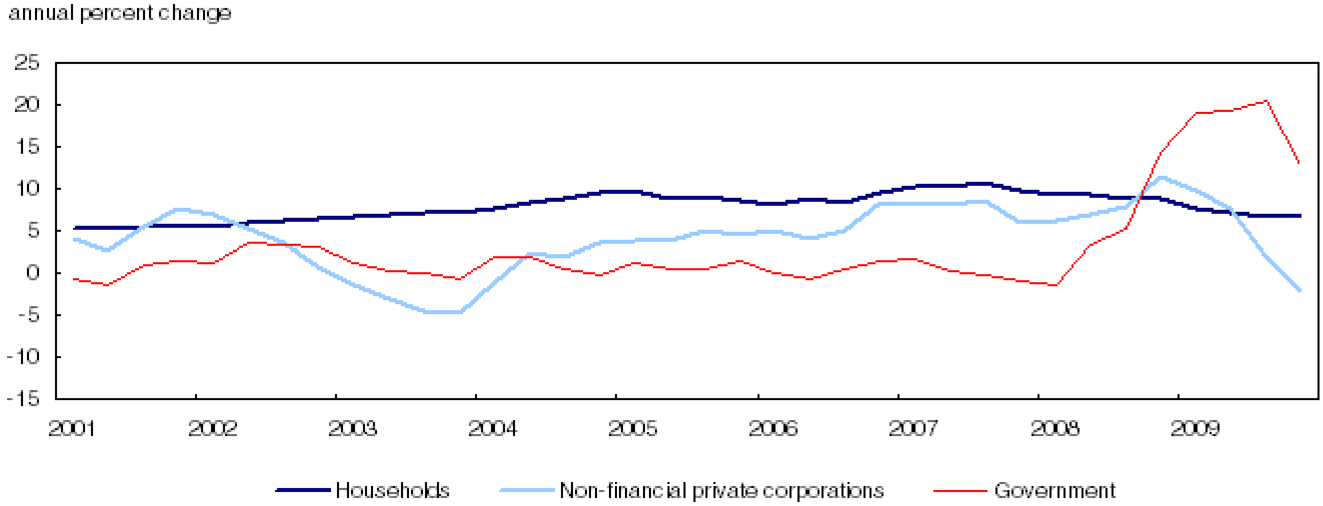


Chart 3.10
Contribution to drop in GDP during recessions

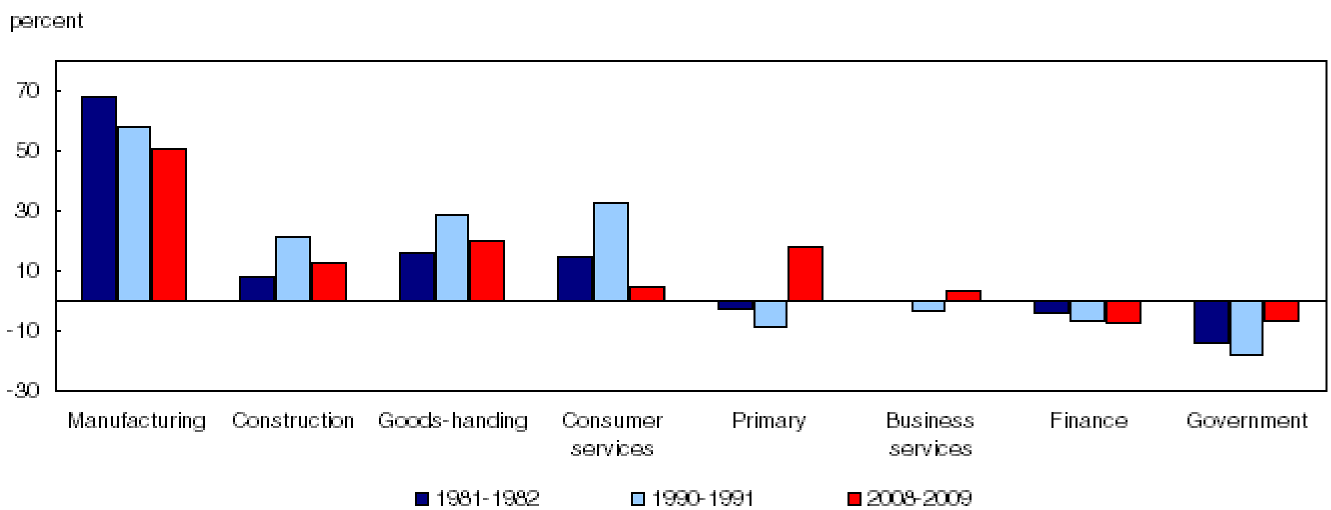


Chart 3.11
Forestry-related and motor vehicle output

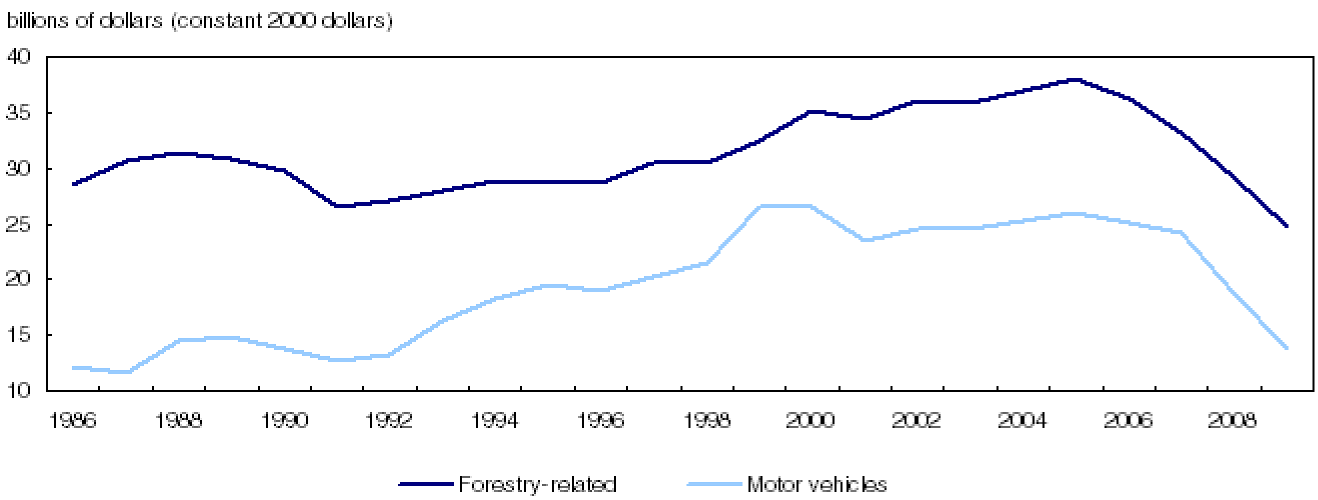
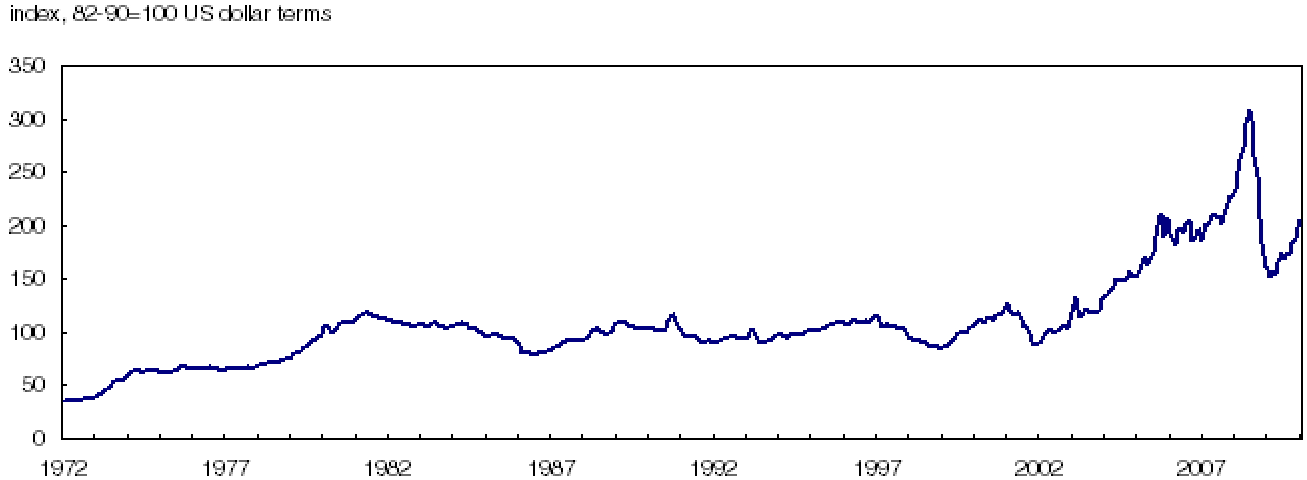


Chart 3.12
Commodity price index



Source(s): Bank of Canada

Text table 3.1
Change in GDP during recessions (constant 2002 dollars)

	Change	Contribution (share of change in total GDP)
1981-1982	billions of constant 2002 $	percentage
Total GDP	-26.1	100
Manufacturing	-17.8	67.8
Construction	-2.2	8.3
Wholesale and transportation	-4.2	16.3
Consumer services	-3.9	15.0
Primary	0.8	-2.9
Business services	0.1	-0.3
Finance	1.1	-4.1
Government	3.7	-14.0
1990-1991		
Total GDP	-23.8	100
Manufacturing	-13.8	58.0
Construction	-5.1	21.3
Wholesale and transportation	-6.8	28.7
Consumer services	-7.7	32.5
Primary	2.0	-8.4
Business services	0.7	-3.1
Finance	1.5	-6.4
Government	4.3	-18.2
2008-2009		
Total GDP	-49.5	100
Manufacturing	-25.1	50.7
Construction	-6.3	12.7
Wholesale and transportation	-10.1	20.3
Consumer services	-2.4	4.8
Primary	-8.8	17.7
Business services	-1.8	3.6
Finance	3.7	-7.4
Government	3.4	-6.9