



Economic Commentary

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Canada — Promise Amid Global Challenges

Economic Outlook — More Growth Now, Less Later

The global economy is transitioning from recession to recovery with assistance of unprecedented monetary and fiscal intervention, and a renewed inventory cycle that has boosted manufacturing activity worldwide. Nevertheless, the pace of activity remains highly uneven across regions and sectors, a function of the slow unwinding of massive debt burdens and the financial crisis that hobbled a number of advanced countries.

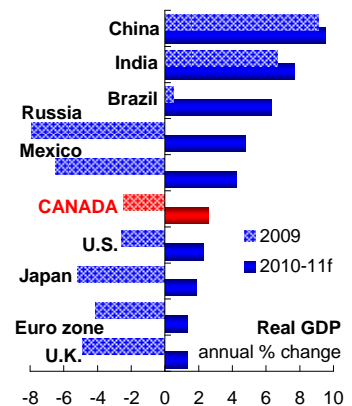
Many emerging nations are recording much stronger growth rates than most, if not all, of the advanced countries — a trend that will likely persist. For the most part, the stronger performances reflect a number of positive factors, including rapidly improving domestic economic fundamentals, competitive exports, and political and financial sector stability. In contrast, the rebound in advanced economies has been quite modest by historical standards. Many of these jurisdictions are still reliant upon extraordinary policy stimulus for support as they enter a multi-year period of economic consolidation and restructuring.

Nevertheless, the pace of activity around the world has begun to lose momentum. The boost to production and trade from renewed inventory accumulation has slowed, despite exceptionally low borrowing costs in most countries, and the solid upswing in corporate profitability internationally. At the same time, recurring bouts of economic and financial market volatility have tended to reinforce caution among investors, consumers, and businesses alike.

A number of structural issues are weighing on growth, particularly in the more heavily indebted advanced economies. First, the sharp downturn in housing activity and prices in the United States and a number of other countries, including the United Kingdom, Ireland, and Spain, has triggered a multi-year period of deleveraging to reduce excessive household debt burdens. Second, the heightened financial market volatility that shook Europe in the spring has accelerated the pace of fiscal consolidation within most euro zone members, and reinforced plans by the advanced economies of the G20 to at least halve bloated government deficits by 2013 and stabilize debt burdens (e.g. debt/GDP) by 2016. Third, businesses remain wary of hiring in many nations because of the uncertainty surrounding the

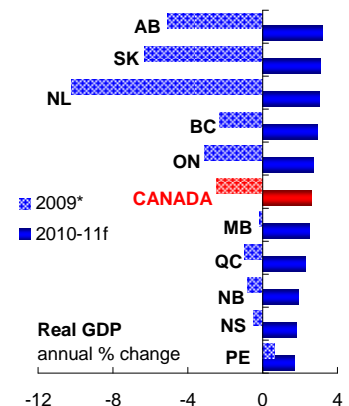
Emerging Nations Are Driving The Global Recovery

Emerging Nations' Economic Leadership ...



Source: Global Insight, Scotia Economics.

... Is Good News For Canada's Resource Regions



* 2009 data preliminary industry-based estimates.
Source: Statistics Canada, Scotia Economics.

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strength and longevity of the recovery, and the expected future costs associated with government fiscal repair and health and pension requirements. Fourth, competitiveness for many economies is being eroded by sub-par productivity gains and continuing volatility in foreign exchange markets. Fifth, the normalization of ultra-low borrowing costs by some countries less affected by the global financial crisis — Canada, Australia, India, Brazil, and South Korea, for example — alongside credit-tightening measures introduced by the globe's perennial global growth leader, China, to cool off its hot real estate markets, will drag on growth. And sixth, banks around the world face the prospect of increased capital requirements and tighter regulations to bolster their defences against renewed economic and financial market volatility.

Combined, these adjustments will likely continue to impose a considerable drag on international growth for the foreseeable future. For most of the advanced economies, a lengthy period of economic convalescence lies ahead. Domestic demand will be challenged by the collective move to fiscal consolidation and, in some countries, the continuing reduction in household debt burdens.

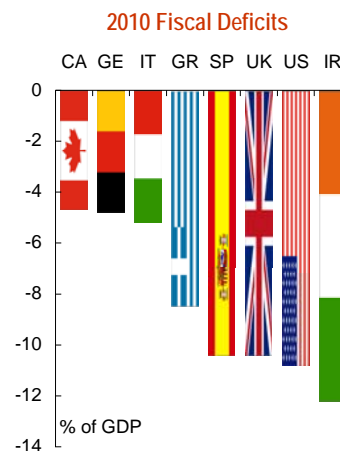
Scotia Economics expects worldwide output growth to average 4.4% in 2010 (based upon a purchasing power parity weighting of 34 countries around the world), followed by an estimated 3.7% advance next year. Combined, the two-year average of about 4% falls nearly a percentage point short of the roughly 5% average gain experienced during the globe's four-year boom period from 2004 through 2007. The emerging economies will continue to drive output growth internationally, paced by China where real GDP is set to expand 10% this year and 9% the next, and followed by India, where advances averaging 8.3% and 7.0% are expected.

Among the advanced economies, both Canada and Germany are expected to record output growth averaging 3.0% in 2010, though Canada is expected to outperform in 2011 — 2.3% versus 1.5% for Germany. After accounting for the renewed downshifting in U.S. growth, we now project that America's real GDP will post a 2.6% gain this year, followed by a more moderate 2.1% advance in 2011. Progressively smaller advances are forecasted in each year for Japan, the United Kingdom, and the euro zone.

Canada — At The Top Of The G7 Growth Ladder

The Canadian economy has been more resilient than most of its G7 counterparts, with the 3.3% loss in output incurred during the recession largely recovered in the four quarters that ended in June. Canada's large resource sector has benefitted from the improving performance in the emerging markets and the associated strengthening in commodity prices. The upswing in the demand for transportation equipment has bolstered manufacturing activity. Very low interest rates and comparatively better household and bank balance sheets have underpinned a revival in residential activity and consumer

Comparatively Better Fiscal Situations In Canada & Germany



* General government basis.
Source: IMF, Scotia Economics.

spending, while businesses are taking advantage of government incentives to bolster purchases of productivity-enhancing machinery & equipment.

During the first year of the recovery, private sector expenditures by Canadians (ie. excluding the support from government spending and the current drag from net trade) increased by 4% — roughly three-quarters of a percentage point higher than the economy's overall gain, and accounting for all of the economy's growth during that period. And even as the Canadian economy slows in response to the reduced prospects in the United States and other regions in the developed world, we expect that private sector purchases will likely continue to outpace the national average by similar metrics through the end of 2011.

Canada's solid pace of economic activity to date is reflected in the strong pace of employment creation. During the first year of the recovery, the country has recouped over 75% of the private sector payroll positions that were cut during the recession. This compares to a less than 10% recovery rate in the much harder hit U.S. workforce. And while unemployment rates on both sides of the 49th parallel have been slow to recede from their recession highs, the jobless rate in Canada is expected to average around 8.0% this year — about 1½ percentage points below the corresponding U.S. level, and roughly half a percentage point below the



European average. Only Japan will post a substantially lower unemployment rate, though its job market remains virtually stagnant.

The country's comparatively stronger domestic performance is also evident in the housing market. Existing home sales and prices have been quite buoyant, spurred in the early months of the year by the broadening recovery, low borrowing costs, impending changes to mortgage eligibility rules, and the mid-year shift to a value-added Harmonized Sales Tax in both Ontario and British Columbia. Although both existing sales and prices subsequently softened over the summer, home sales remain at relatively elevated levels and average prices are near all-time highs. With new homes sales picking up as well, homebuilding is running at an annualized rate of around 195,000 units in the first eight months of 2010, 30% higher than the recession-low average established in 2009, but still 15% below the cycle high of 229,000 units established in 2007. Canadians also took advantage of temporary renovation credits — pumping up retail sales in the building/outdoor services sector.

Notwithstanding the recent pullback in housing activity and prices, and the potential for even further consolidation ahead, Canada's residential real estate market has largely avoided the significant retrenchment experienced in the United States and some European countries. Over the past decade, the aggregate value of residential buildings excluding land held by Canadians (based on national balance sheet data) has doubled. However, the value of the land on which these structures stand has increased two-and-a-half fold. Land values now account for close to 50% of the estimated value of residential properties, up from less than 40% in 1990.

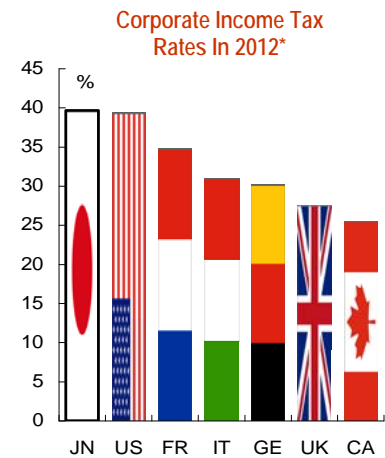
While Canada's economic recovery has been notable, it would have been even more impressive if not for the drag caused by the steady erosion in net trade. The growth in imports to satisfy both Canada's stronger domestic spending profile and increasing international demand for manufactured products has more than offset the improving trend in exports experienced during the recovery. Although exports of autos and commodities, primarily to the United States and the Asia-Pacific region, are on the mend, they are still only four-fifths of the levels reached during the height of the commodity boom in mid-2008.

Canada — Promise Amid Global Challenges

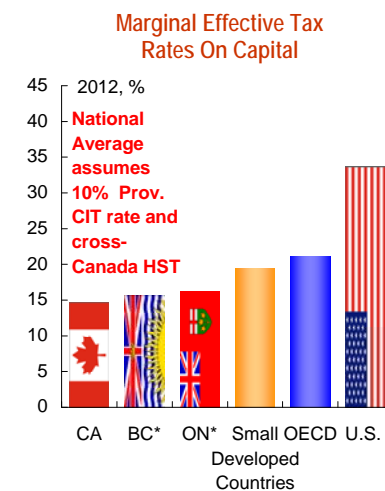
Looking ahead, Canada should remain one of the top performers among the advanced nations:

- The Canadian economy is highly diversified, thereby enabling it to better withstand the variability in global growth trends and shifts in competitiveness. The broad service sector represents roughly 70% of national output. The goods-producing sectors account for the remaining 30%, of which manufacturing is close to half and construction/utilities represent roughly a one-third share. Moreover, Canada is in the enviable position of being a resource-rich country in

Canada's Tax Regime Provides A Competitive Edge



* National and sub-national statutory rates. Source: Finance Canada, OECD, Scotia Economics.



* Rates when HST fully implemented in 2018. Source: Finance Canada, Ontario and B.C.

a resource-short world. Over the next decade, the impetus for global growth will come increasingly from powerhouses such as China, India, and Brazil. Rapidly rising incomes in these high-growth countries are fuelling an extraordinary expansion in their domestic demand. China, which has replaced Japan as the second-largest purchaser of Canadian exports, sells — and produces — more cars and trucks than the U.S., Canada and Mexico combined. Commodities account for 47% of Canada's export receipts, with energy and mining products representing about 20% and 13% respectively, and other commodities accounting for about 14%. *By leveraging its natural resource*



development, Canada can benefit from the stronger growth expected in the emerging markets, thereby helping to counter some of the drag from slower U.S. activity.

- Canada's fiscal finances are in a comparatively healthier position than those of the other G7 nations whose balance sheets, for the most part, were seriously eroded by the recession and subsequent support packages. Canada's general government deficit as a share of GDP approached 5% in 2009 — just behind Germany's roughly 3¼%, but considerably below the sharper erosion in the deficit-to-GDP ratios posted by Japan at about 10%, the United Kingdom at close to 11%, and the United States, where the ratio ballooned to over 12%. With the recovery underway, the IMF uses country-specific budgets to forecast that Canada will almost eliminate its general government deficit by 2014, the only G7 nation expected to do so. Germany's deficit-to-GDP ratio should be narrower than 2%, while the United States remains saddled with a 6% deficit share. This relative outperformance will result in Canada's gross general government debt share of GDP falling to just over 70% by 2014 from more than 80% in 2009 — the only G7 country expected to post a reduction. *Canada's comparatively better fiscal position provides the country with the added flexibility to deal with longstanding competitive issues to strengthen its longer-term performance.*
- Canadian banks weathered the financial crisis that enveloped the globe much better than their G7 peers, with the downdraft in performances reflecting the general economic contagion and not a systemic threat to the system. Subsequently, share prices and earnings have rebounded solidly alongside the nascent recovery. Much of this outperformance relative to other advanced nations reflects a number of key factors: Canadian banks are generally better capitalized, have strong liquidity positions, and are more diversified, from both a funding (more reliant on deposits rather than wholesale markets) and geographic perspective. Moreover, Canada's more stringent regulatory environment, coupled with the banks' more conservative strategic view, helped to discourage excessive risk-taking that undermined many financial institutions throughout the G7. *Accordingly, Canada's banks are in a favourable position to continue to support credit growth and economic activity, both at home and internationally.*
- Canada's diversified economy remains an attractive destination for global businesses to expand their operations. Foreign direct investment in Canada has resumed after the recession's temporary interruption, with inflows amounting to around C\$47 billion over the past year — slightly above the average yearly inflow experienced over the past decade. The country's proven longer-term commitment to fiscal repair is facilitating further decreases in federal and provincial tax relief that will increasingly enhance Canada's competitiveness over the next few years compared to its G7 counterparts — now and in the future when more stringent

measures will be required to reverse the fiscal deterioration in other countries. Canada's statutory federal and average provincial corporate income tax rate has been trimmed to just under 30%, with a plan to reduce it to towards 26% in 2012. In comparison, the corporate tax rate slated for Germany in 2012 is expected to be 30%, and close to 40% in both the United States and Japan. Similarly, Canada's marginal effective tax rate on capital investment is set to fall to roughly 15% by 2012, versus a projected average of just over 20% in the OECD countries, and 34% in the United States. Furthermore, Canada, unlike many nations, has already addressed the solvency issue with regard to its national social security plan, the Canada Pension Plan, a development that should help the country weather the fiscal strains associated with the impending retirement of the baby boomers. *A highly competitive tax environment should remain a strong magnet for investment in Canada, particularly during this period of unsettled economic and financial conditions around the world.*

- Canada's large economy contrasts with its small population, totalling almost 34 million residents in 2009 and expanding at an annualized rate of 1.1% over the second half of the past decade. The higher-growth western and northern regions have registered the fastest population growth rates in recent years, followed by the large and heavily-populated central provinces of Ontario and Quebec. Like many advanced nations, an ageing demographic profile has limited the growth in Canada's population. However, unlike the situation of some of its peers in Europe and Japan, international immigration into Canada has remained quite strong — averaging 250,000 per year — contributing to roughly 70% of the gain in population since 2005. *Favourable economic and job market conditions, competitive tax rates and a strong Canadian dollar remain supportive of continued immigration and an expanding workforce.*

These factors should help reinforce a more constructive outlook for Canada during an extended period of economic consolidation and restructuring affecting many highly indebted nations, particularly among the advanced countries of the world.