United States Capitol. Courtesy: https://en.wikipedia.org

Global Economic Environment

According to the International Monetary Fund (IMF), world gross domestic product (GDP) growth was 3.1% in 2016, moderately lower than the 3.2% observed in 2015 and the 3.4% in 2014 (see table). Global growth has been decelerating since the most recent peak of 4.2% in 2011. The slowing growth is, to a certain extent, attributed to the deceleration in emerging market economies (EMEs), notably China.

For the past several years, growth in EMEs (particularly China) has been the main driver of global growth. During the first decade of the new millennium, China, currently the world's largest economy, recorded annual average real GDP growth of 10.5%. In contrast, China's economic growth has decelerated over the past five years, falling to 6.7% in 2016.

The slowing pace of economic growth in the EMEs, combined with oversupply, has placed downward pressure on several commodity prices, such as oil and iron ore. These prices improved in 2016, but remain low compared to recent peak levels. For example, the price of crude oil (Brent) in December 2016 was approximately 50% lower than the level recorded in June 2014. A similar story holds true for several base metals such as iron and nickel. This has negatively affected most commodity exporters, including Russia and Brazil, which experienced recessions in 2016. Although Canada is considered a commodity exporter, it has remained relatively resilient to the downturn, but not uniformly across provinces.

Monetary policies across nations are now diverging. The Federal Reserve Board in the United States increased its target interest rate (the Federal Funds Rate) by 0.25 percentage points in March 2017, following two similar increases since December 2015. On the other hand, the European Central Bank and Bank of Japan remain in full-scale stimulus mode.

Real GDP Growth (%)

	2015	2016	2017f	2018f
World	3.2	3.1	3.4	3.6
Brazil	-3.8	-3.5	0.2	1.5
India	7.6	6.6	7.2	7.7
Russia	-3.7	-0.6	1.1	1.2
China	6.9	6.7	6.5	6.0
Canada	0.9	1.4	2.0	1.9
United States	2.6	1.6	2.2	2.1
Japan	1.2	1.0	0.8	0.5
Australia	2.4	2.9	2.7	2.9
European Union	2.3	1.9	1.7	1.8
United Kingdom	2.2	1.8	1.5	1.4
Euro Area	2.0	1.7	1.6	1.6
Ireland	26.3	4.9	3.2	3.1
Germany	1.5	1.9	1.5	1.5
France	1.3	1.2	1.3	1.6
Italy	0.7	0.9	0.7	0.8
Spain	3.2	3.2	2.3	2.1
Portugal	1.5	1.0	1.1	1.2
Greece	-0.2	0.1	2.8	3.1

f: forecast
Source: Various, available upon request

The Bank of England decreased its bank rate in August 2016 while the Bank of Canada kept its bank rate unchanged throughout the past year.

Additional uncertainty looms over global trade due to rising protectionist pressures and uncertain policy shifts. The latter is demonstrated by the decision of the United Kingdom to leave the European Union (EU), while the former is demonstrated by the new U.S. administration, which has rejected the Trans-Pacific Trade agreement and pledged to re-negotiate NAFTA.

The IMF projects a 2017 growth rate in real GDP of 3.4% for the world, 1.9% for advanced economies and 4.5% for EMEs. Global growth of 3.6% is currently expected in 2018.

United States

U.S. economic growth has been steady but moderate in recent years. Real GDP increased by 1.6% in 2016, following 2.6% growth in 2015.

Consumer spending, which accounts for about two-thirds of U.S. economic activity, was the main driver of GDP growth in 2016, growing by 2.7%.

Fixed private investment increased by 0.7% in 2016 as gains in residential investment offset lower non-residential spending. Non-residential private investment decreased by 0.5%, the first annual decrease since the last recession. Investment was impacted by a slowdown in the energy sector, due to the falling price of crude oil. Unused capacity persists in the energy sector, deterring further investments. Generally speaking, investment follows the industrial capacity utilization rate, which has yet to recover from its decline in 2015.

Residential investment continued its upward trend. Housing starts increased by 5.6% in 2016 (1.2 million units). However, the number of starts remains lower than the pre-recession average, with an annual average of 1.7 million units between 2000 and 2007.

The exports sector remained challenged due to the rising value of the U.S. dollar. The trade-weighted U.S. dollar index increased substantially since the beginning of 2015, due in part to diverging monetary policies between the U.S. and several of its trading partners. Growth in real exports of goods and services increased by 0.4% in 2016.

Labour market conditions in the U.S. continued to improve in 2016. The unemployment rate further decreased, reaching 4.5% in December, one of the lowest rates since 2008. Employment increased by 1.7%, while the participation rate remained relatively unchanged. In addition to job gains, average hourly earnings in the private sector (a key catalyst for consumption growth) increased by 2.4%.

Tightening labour markets and wage gains, together with rising commodity prices, have altered expectations on inflation. The year-over-year monthly inflation rate was 2.7% in February 2017, the highest in five years. Increasing inflation led the Federal Reserve to increase the Federal Funds Rate in March 2017, following similar increases that occurred in December 2015 and December 2016. Monetary policy is gradually moving away from stimulus mode, which began in December 2008. The Federal Funds Rate is now between 0.75% and 1.00%, or 75 basis points higher than the prevailing rate between 2008 and 2015. It is expected that the target rate will be increased gradually in the future, but the pace and timing of those increases will be dependent on economic performance. For the time being, the target rate remains low by historical standards.

The U.S. economy is expected to expand by 2.2% in 2017. Consumer spending and the housing market are expected to drive growth, buoyed by pent-up demand, job gains and increasing incomes. However, the strength of the U.S. dollar will constrain exports. Capital spending could increase once more with an improvement in commodity prices, although the recovery remains partial. Real GDP growth is expected to reach 2.1% in 2018.

United Kingdom

On June 23, 2016, the United Kingdom (UK) held a referendum with the question "Should the United Kingdom remain a member of the European Union or leave the European Union?". Contrary to expectations, "Leave" won over "Remain", with 51.9% of the vote. In the aftermath of the referendum, Prime Minister David Cameron offered his resignation and the financial markets experienced another sharp episode of turmoil. Although this heightened volatility proved to be short-lived, the underlying uncertainty remains, namely how this will affect trade between the UK and the EU, as well as other nations. A tangible consequence is the postponement of investment and hiring decisions in the area, particularly in the UK, as firms are less willing to take risks with so many unknowns. As well, the pound sterling markedly depreciated after the vote. The government has yet to release a transition plan.

Following the referendum, the Bank of England adopted a number of supportive measures in August 2016, including a cut in its Bank Rate, citing a short to medium term outlook that has deteriorated in the wake of the UK's vote to leave the EU.

Despite concerns that the referendum results would negatively impact economic activity, data covering the two quarters following the referendum reported strength rather than weakness. On an annual basis, real GDP for 2016 increased by 1.8%, with consumer spending (up 3.1%) offsetting lackluster business investments (down 1.5%).

In its January update, the IMF forecasts the UK economy to grow by 1.5% in 2017, followed by 1.4% in 2018.

Euro Area

The Euro Area consists of the 19 jurisdictions within the European Union that have adopted the euro as its currency. Collectively, the Euro Area accounted for 11.8% of global GDP in 2016, with the largest economies being those of Germany, France, Italy and Spain. While 2016 year-end results for all Euro Area jurisdictions were not released at the time of writing, overall Euro Area real GDP growth is expected to be about 1.7%. Low energy prices and improving labour markets continue to support disposable household income, and thus consumption. Net exports also contributed favourably to these results.

In 2016, Germany and France recorded increases in real GDP of 1.9% and 1.2%, respectively. Most members of the Euro Area reported or are expected to report increases in real GDP. Ireland is poised to have the highest growth rate of the area.

The European Central Bank (ECB) launched its Quantitative Easing (QE) program in early 2015 in response to continued sluggish growth and inflation oscillating around zero. This program committed to purchase European bonds worth €60 billion per month until September 2016. The ECB later extended the plan to continue purchases to March 2017, including corporate bonds, and increased purchases to €80 billion monthly starting April 1, 2016. After March 2017, the program will continue until the end of the year at a reduced pace of €60 billion monthly, with the possibility of further extension.

In addition to its QE program, the ECB has been carrying out a negative interest rate policy since June 2014 by maintaining a negative interest rate on its overnight deposit facility. The purpose of negative interest rates and QE is to boost overall growth and increase inflation to around 2%. The ECB stated that it intends to conduct its QE policy until reaching this inflation target.

Risks to the economic outlook of the Euro Area persist. Italian banks are in the midst of a bailout as they carry a large number of non-performing loans. Italy is considered to be in a climate of political instability. A constitutional referendum held in December 2016 was rejected by the population. Also, the sovereign debt crisis in Greece, which has not been settled, could resurface—the country has yet to implement several reforms that were conditions of the agreed bailout package in 2015.

The IMF projects annual real GDP growth in the Euro Area of 1.6% for each of 2017 and 2018. The most recent ECB Survey of Professional Forecasters predicts that the unemployment rate will decrease from 10.0% in 2016 to 9.5% in 2017 and 9.2% in 2018.

China

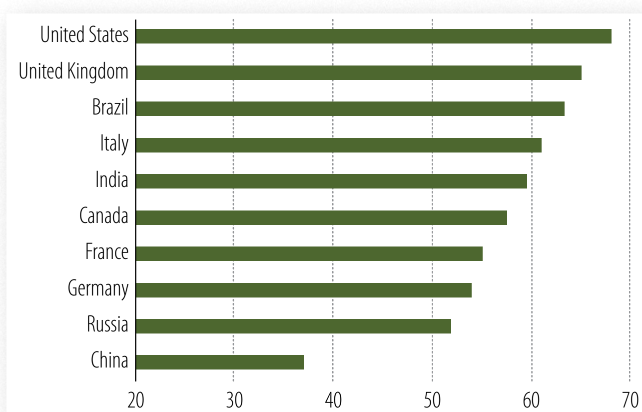
The Chinese economy expanded by 6.7% in 2016, following 6.9% growth in 2015. Although significantly lower than the annual average rate of 10.4% recorded between 1992 and 2007, such growth rates remain markedly above those recorded in advanced economies. GDP growth was aided by higher government spending and a decline in imports. While the latter may be seen as a positive for China, it is a negative for countries dependent on China for exports, particularly commodity producers.

The Chinese economy is in the midst of important structural changes, with the government committed to transitioning the drivers of growth from manufacturing and investment to services and consumption. Compared to both developed and developing countries, China's consumption as a share of GDP is unusually small (see chart).

Despite the stated restructuring goals, in recent years, the government has maintained its fiscal and monetary intervention in the economy to improve short-term performance. This could potentially slow the rate of restructuring.

The Chinese government identified several challenges to be tackled in 2016 and beyond. These include decreasing overcapacity within less efficient and highly indebted state-owned enterprises, notably in heavy industrial sectors, such as steel, cement and mining. It will also aim to reduce the excess housing inventory as supply (in terms of new units) has exceeded the demand in several regions (houses being built where the government says so, not where the demand is).

Household Final Consumption Expenditure as a Percent of GDP, 2015



Source: World Bank

The near-term performance of the Chinese economy was a major concern early in 2016, yet the year was marked by relative stability, notwithstanding strong governmental support. The IMF expects real GDP growth in China to be 6.5% in 2017 and 6.0% in 2018.

Japan

Japan is the world's fourth largest economy, accounting for 4.1% of world GDP on a purchasing power parity basis in 2016. The country has experienced a number of serious economic difficulties over the past two decades with persistently low inflation or deflation, increasingly high levels of government debt and weak private sector growth. Over the past 20 years, Japan's real GDP has increased by an annual average of only 0.7% and inflation has averaged only 0.1% per year. In addition, due to a rapidly aging population, Japan's public finances are under sustained pressure, particularly for health and long-term care expenditures, which are difficult to constrain.

In 2013, the Government of Japan launched a three-pronged approach for economic recovery through fiscal, monetary and structural policies. These policies include a large fiscal stimulus program; measures by the Bank of Japan to increase the money supply, including the introduction of quantitative and qualitative monetary easing; and structural reforms such as reducing protectionism for selected industries and reducing labour market rigidities. Thus far, these policies have had only limited success.

Real GDP increased by 1.0% in 2016, supported by exports and investments. Although the unemployment rate is at a 20-year low, evidence of wage pressure remains scant. Consequently, the inflation rate has remained either slightly negative or about zero percent in 2016, well below the Bank of Japan's 2% target rate. In January 2016, the Bank of Japan applied its first negative interest rate (-0.1%) to current accounts that financial institutions hold at the Bank, and has indicated that it will keep or reduce this rate further, if necessary.

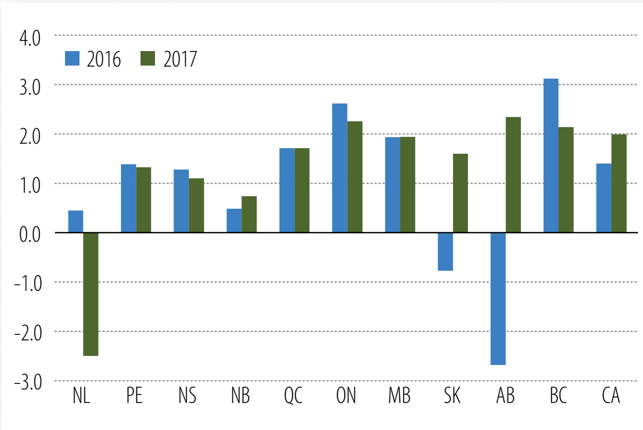
The IMF expects the growth rate of Japan's economy to continue to vary between 0% and 1%, with real GDP growth forecasted at 0.8% in 2017 and 0.5% in 2018.

Canada

During the last decade, economic growth in Canadian provinces with a large commodity sector, notably fossil fuels, surpassed the national average. Several other provinces, particularly Ontario and Québec, were left to deal with faltering manufacturing sectors, due to increasing global competition and appreciation of the Canadian dollar. The collapse of crude oil prices and consequent Canadian dollar depreciation has led to a reversal of fortunes. Alberta and Saskatchewan are estimated to have recorded negative real GDP growth in 2016 (see chart). On the other hand, British Columbia, Manitoba, Ontario and Québec are estimated to have posted growth at or above the national average. The Canadian economy grew by 1.4% in 2016. Growth was solid in the first quarter of 2016 but the second quarter recorded a decline, notably due to the wildfires around Fort McMurray and the associated interruptions in the oil industry. Activity picked up considerably in the last two quarters of 2016.

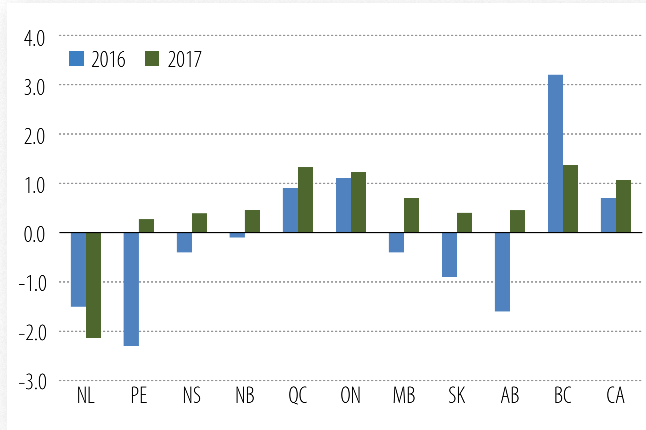
Real GDP growth in 2016 stemmed primarily from consumption as investment was constrained by lower spending in the mining and oil and gas sectors. Exports were dampened as well. Canadian retail sales increased by 3.7% in 2016. Household indebtedness has been steadily increasing since the early 1990s and reached a record high last year. Thus far, debt levels have proven to be sustainable due, in part, to a low interest rate environment. The ratio of interest payments to disposable income is currently at a historically low level. However,

GDP Growth Rates, by Province



Note: Growth rates in this chart for NL may differ from the Department of Finance forecast outlined on page 16.
Source: Statistics Canada; Average of Canadian major banks and the Conference Board of Canada

Employment Growth, by Province



Source: Statistics Canada; Average of Canadian major banks and the Conference Board of Canada

if interest rates rise, interest payments would increase and consumers may not have the freedom to increase expenditures, thus limiting the contribution of consumption to future GDP growth. In efforts to reduce risk-taking in housing markets, the Federal Government unveiled a tightening of mortgage rules in October 2016. The new rules will require new homeowners to test their ability to meet more stringent conditions such as higher interest rates (see *Real Estate*).

Capital investment in Canada declined by 3.2% in 2016. Higher residential expenditures were offset by lower non-residential investment, constrained by lower spending in mining and oil and gas sectors. The marked depreciation of the Canadian dollar in 2015 increased the cost of imported machinery and equipment, thus curtailing expenditures.

Housing starts increased by 1.2% in Canada in 2016. Performance varied by province. Increases in Québec, Ontario and British Columbia more than offset decreases in all other provinces. Growth in B.C. was particularly strong (over 33%). Elevated real estate prices have stimulated new housing activity in the Vancouver area.

The value of exports of goods declined by 0.7% in 2016 due to price declines. Real exports of goods (measured on a volume basis) increased by 0.5% for the year.

In response to a slowing economy, particularly in commodity dependent provinces, the Bank of Canada lowered the target overnight bank rate twice in 2015—by 25 basis points in January and by another 25 basis points in July—in an attempt to boost investment and stimulate economic growth. The target overnight rate has remained unchanged since then, at 0.5%.

In tandem with a modest recovery in commodity markets, the Canadian dollar appreciated in 2016, reaching approximately 75 cents US in December. This uptick follows a steady depreciation throughout 2015, when the Canadian dollar declined from around 85 cents US at the start of 2015 to around 72 cents by the end.

Labour market performance varied across Canada in 2016 (see chart). Employment grew by 0.7%, due to gains in Québec, Ontario and British Columbia. Nationally, employment gains were mainly in part-time employment, with some modest increase in full-time employment. The unemployment rate increased by 0.1 percentage points to 7.0% as a result of more people entering the labour force.

Average weekly earnings for 2016 grew by 0.5% nationally.

The latest forecast from major Canadian banks and the Conference Board of Canada expects real GDP growth in Canada to be 2.0% in 2017. Continuing low interest rates and higher federal government transfers should support consumption. According to Statistics Canada, non-residential investment in Canada for 2017 is expected to be up 0.8%. This number is only tentative and actual investments may differ. Other indicators, such as the Bank of Canada's latest Business Outlook Survey (Winter 2017) indicated that investment intentions over the next 12 months have improved in all regions and sectors, especially among exporters. The partial recovery in mineral and energy prices will increase the value of exports. The low dollar and solid U.S. demand are expected to contribute to gains in exports in 2017.

Economic growth in 2017 is expected to be broad-based across Canada with the exception of the Atlantic provinces (negative for Newfoundland and Labrador and below the national average for Maritime provinces). British Columbia, Ontario and Alberta are expected to lead in terms of real GDP growth.