The Economy and You

A look at the major factors influencing and affecting our economy, and in turn, our financial lives.

CANADIAN BANKERS ASSOCIATION
Building a Better Understanding

On behalf of the banking industry, the Canadian Bankers Association has embarked on a program called Building a Better Understanding. This is our commitment to communicate better and to provide useful financial information to Canadians.

As part of the program, we are offering a free series of publications, ranging from money management and interest rates to mortgages, starting a small business and saving for your children's education. To obtain copies, call toll-free 1-800-263 0231 or visit our web site at www.cba.ca. You can also order by writing to Building a Better Understanding, c/o Canadian Bankers Association, Box 348, Commerce Court West, 199 Bay St., 30th floor, Toronto, Ontario M5L 1G2.

Published by the Canadian Bankers Association August 1998.

Copyright Canadian Bankers Association 1998. All rights reserved.

These publications are also available in alternative formats for people who are partially sighted or have limited vision.

La version française de cette brochure est disponible sur demande.

This booklet gives information of a general nature and is not intended to be relied on by readers as advice in any particular matter. Readers should consult their own advisors on how this information may apply to their own circumstances.

Table of Contents

The Canadian Bankers Association would like to thank the Bank of Canada and the Canadian Foundation for Economic Education for their input and suggestions.

While we influence the economy through our activities, at the same time, our decisions and lives are impacted by many broad and diverse economic forces happening around us.

Introduction

Understanding what makes the economy tick is a challenge for many Canadians. While most people are interested in how the economy personally affects them, there are so many factors to consider. Fluctuating interest rates, the value of our dollar, the national debt, inflation, international trade – all have an impact on our daily lives. But putting these pieces together for the bigger economic picture is not always easy.

Even the word “economy” can be a little forbidding. Really, the economy is everything that surrounds us in our daily lives. It’s where we work, what we earn, what we spend and how we spend it, what and where we invest, where we live, our savings, the value of our dollar, our interest rates, what it costs to fill up the car, where we take our vacation, how much we pay in taxes, and so on.

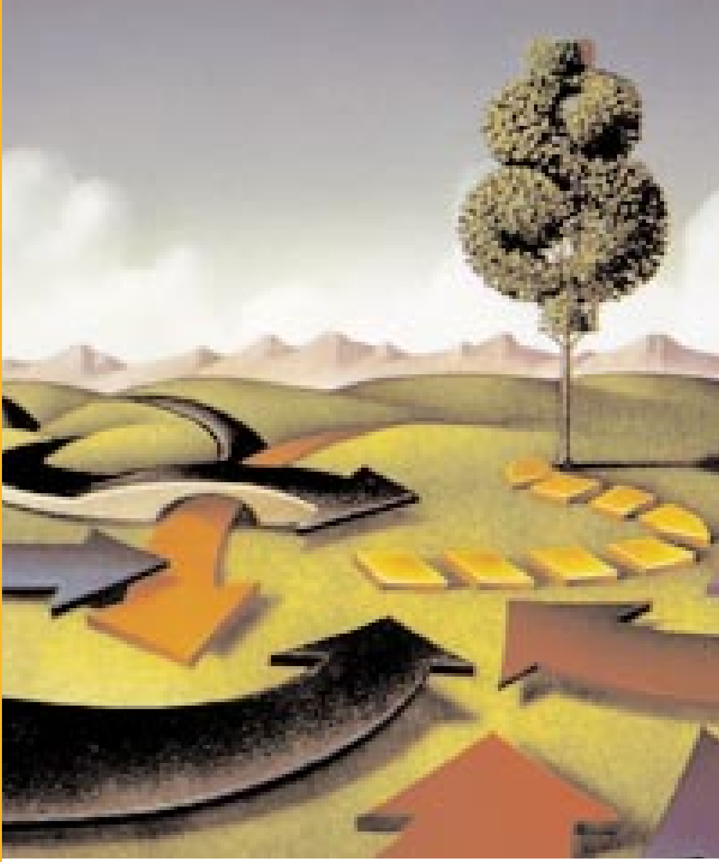
To help demystify the economy, we have put together some key economic pieces to build a bigger picture. The results of a recent Canadian Bankers Association survey support this effort – Canadians said they want to know more about the economy and how it works. Approximately 67% of Canadians felt that if they knew more about the economy they would be better equipped to make decisions about their own financial affairs.

Our goal with this booklet is to offer information on the major factors influencing and affecting our economy, and in turn, our daily lives. Being aware of what’s going on and knowing how to interpret economic information can help us with the financial decisions we have to make – our daily spending, big-ticket purchases, investments, savings, retirement planning, financial management, borrowing and credit decisions, to name but a few.

Although we are taking a “big picture” look at the Canadian economy, keep in mind that economics is much more. It’s also about the actions of individual consumers and firms. At the end of the booklet, we have suggested a number of resources for more information.

We hope you find this booklet useful.

The Big Picture



The economy is really all about each of us. We affect and are affected by the economic world.

Decisions by business, consumers, savers, borrowers, investors, and governments have an impact on demand, production, growth in the economy and job creation. Whatever one group does affects the others.

For instance, if consumers reduce the amount of goods/services they purchase, this affects business revenues. This, in turn, will have an impact on the business's need for resources, such as labour and raw materials, as well as the taxes paid to the government. A change in the amount of taxes paid to the government will affect the amount the government can spend. It will also affect the level of employment, which in turn, influences consumer confidence.

While we influence the economy through our activities, at the same time, our decisions and lives are impacted by many broad and diverse economic forces happening around us. "Big picture" factors include:

· Interest Rates
· Inflation
· Foreign Exchange Rates and Our Dollar
· Our Saving and Spending Patterns
· The Financial Markets
· The Bank of Canada's Policy
· Government's Role
· Global Forces

Let's look at each of these…

Interest Rates

Borrowing and saving is a fact of life for most Canadians, making interest rates a key factor in economic activity. When it comes to interest rates, we are pulled in two directions – as savers we want a healthy return on our savings and, as borrowers, we want to pay as little as possible. There's usually a balance of some sort – for instance, low interest rates are good for businesses and other borrowers, but difficult for senior citizens relying on fixed income investments.

Whether you're shopping around for a loan or deciding where to invest money, it's important to look at the level and direction of interest rates. For example, if you are thinking about buying a home or renewing your mortgage, the direction of interest rates will have a bearing on your decision. Will you buy now if interest rates are low or later if you think rates will come down? Will you lock in your mortgage at current rates for five years or will you renew every six months, hoping that rates improve?

When interest rates are low, it's usually a better time to borrow money for big-ticket items, such as a house, a vehicle or major appliances. Sharp hikes in interest rates, on the other hand, may cause you to cut back on your spending and borrowing and could add to interest payments on your existing debt (if not fixed for a specific period).

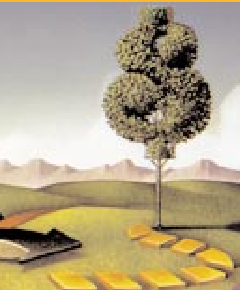
The same goes for business. When interest rates are high, companies may delay expenditures or expansion since the cost of borrowing money may be too high. This could have an impact on job creation and the rate of employment.

If you are saving/investing money for future purchases or retirement, interest rates can influence your investment choices. For instance, when interest rates are low, there is generally less incentive to save money through investments that pay interest (i.e. GICs, term deposits and savings bonds.) If you are planning for your future retirement income, the level of interest rates is an important consideration. If your savings strategy is based on interest-bearing investments only and interest rates are low, your future income isn't likely to be as high as if you had a more diversified portfolio of investments that offered better returns (some stocks or mutual funds).

What makes interest rates go up and down?

There are several factors, including global market forces, the current and expected rates of inflation and monetary policy. The demand for and supply of money in the overall economy is important. When more people want to borrow money than lend money, the price of borrowing will rise. As a result, interest rates go up, prompting more people to save either by deliberately putting more into investments or deferring their borrowing. (Interest rates are not the price of money, but the price of borrowing money. Think of it as paying rent.)

Short-term interest rates are affected by the actions of both the Bank of Canada and other market participants in Canada and abroad. As the country's central bank, it is responsible for overseeing monetary policy. The Bank of Canada (discussed in a later section) influences short-term interest rates by setting the Bank Rate. This is the rate of interest it charges major financial institutions for borrowing.



The Bank Rate serves as an indicator of what will happen to interest rates in general, but usually on a short-term basis. For instance, when the Bank of Canada increases the Bank Rate, this often signals a rise in other interest rates. These include the "prime rate" which financial institutions charge their most credit-worthy customers (those representing the least amount of risk), as well as the rates paid by all other borrowers. Financial institutions typically alter their prime rate immediately following a change in the Bank Rate. The prime rate is an important indicator that is published daily in major newspapers.

On the other hand, long-term interest rates are affected more by the expectations of investors. If they believe inflation will rise in the future, they will demand a higher return on their fixed income investments, causing interest rates to rise.

How have interest rates in Canada varied over time?

Interest rates in Canada have been highly variable over the last 25 years. For instance, the Bank Rate has varied from a high of 21.03% in 1981 to a low of 3.25% in 1997. The reason for this general decline has been the reduction in inflation and improved government finances. When inflation is low, lenders don't need high interest rates to compensate them for the erosion of the purchasing power of the money they lend.

For more information on interest rates, please refer to *The Interest in Your Life*, also published by the Canadian Bankers Association.

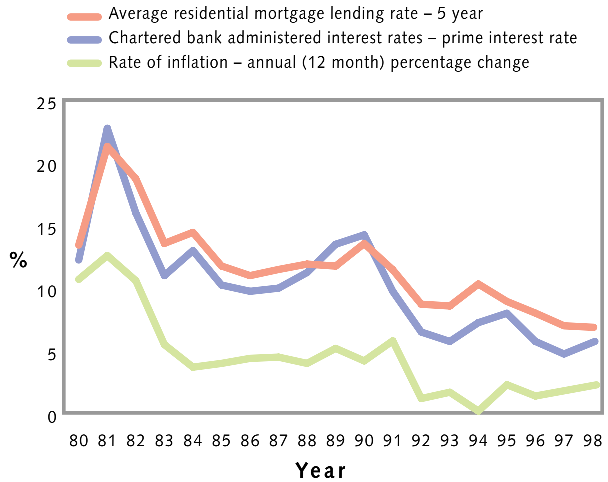
Inflation

Another key influence on the economy is inflation, which is an ongoing increase in the general level of prices of most goods and services.

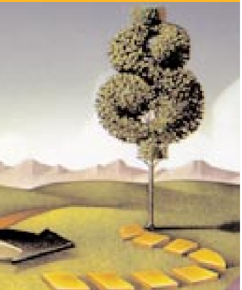
An increase in inflation means that prices are starting to rise. Inflation is also a signal that interest rates may soon increase. This is because lenders want to be compensated for inflation when they lend money. The greater the rate of inflation, the faster your purchasing power dwindles. In other words, your dollar doesn't go as far.

Inflation eats into your savings and investment earnings. If the interest rate on your bank account is less than the inflation rate, your savings won't buy as much as before. Inflation is especially difficult on seniors and others living on fixed incomes that are not indexed for inflation.

Comparing Interest and Inflation



Source: Statistics Canada and Bank of Canada.



Keep in mind that inflation is a general indicator, a trend in overall prices. It's still possible for prices of individual items to fall even when inflation is high.

The opposite of inflation is deflation or a decrease in the general level of prices in the economy. Deflation increases the purchasing power of your dollars.

When general price levels in the economy remain more or less constant, this is known as price stability.

What causes inflation?

When economic growth is rapid, consumer demand for products and services is often greater than the supply. In other words, it's a case of too much money chasing too few goods. Inflation also could arise from increases in production costs or a falling Canadian dollar.

For example, if the supply of money doubled, but the amount of goods and services available for purchase remained the same, the price of most goods and services would double. If our wages also doubled, does this mean we're better off? No, because we can still only purchase the same quantity of goods and services – they just cost twice as much because production costs are higher.

How does inflation affect my investment earnings?

It is important to understand the difference between the interest rate you pay or receive and the real interest rate. The rate you pay or receive – also called the nominal interest rate – is the one you see posted in your financial institution's window. It is the rate that's quoted when you ask about a loan or about investing your money in a GIC or term deposit. But it's not an accurate indication of your true cost of borrowing or the real increase in your wealth. In order to get your "real" rate of interest, you need to subtract the rate of inflation.

Let's assume you invest $1,000 at 5% interest for one year. Over the same time period, inflation is 2%. Although you will earn 5% or $50 of interest on your investment, does that mean that you can purchase 5% more goods and services than last year? The answer is no. Since prices have risen by 2% the true increase in your ability to purchase goods and services is only 3%. We could say that your "real" wealth has risen by 3% rather than 5%.

Here is the formula:

Nominal Interest Rate - Inflation Rate = Real Interest Rate
(Posted rate) (What you effectively earn)

Tip:

Financial experts recommend you consider inflation trends when doing financial planning. Your investments, at the very least, should keep pace with the rate of inflation. The inflation rate is regularly published in major newspapers.
Also keep in mind that interest is taxable, so pay attention to your after-tax returns.

At the end of July 1998, the Canadian dollar hit a low of 66.14 cents (U.S.). Meanwhile, our economy seemed stronger than it has been in several years – lower unemployment, high productivity, strong consumer confidence, low inflation and improved public finances. So why did our dollar drop so low?

While there is no single reason, three factors played an important part – worsening economic conditions in Asia, particularly Japan, a greater demand for U.S. currency and lower interest rates in Canada than in the U.S.

Why is inflation bad?

It reduces the value of our money and our purchasing power. Here are two examples of how people are hurt by inflation:

- You do not anticipate inflation and sign a two-year contract to work for $20 an hour. If inflation causes prices to increase by 10% per year, the purchasing power of your $20 will have decreased by approximately 20% by the end of your contract. In essence, it is really like working for $16 an hour.
- You retire on a fixed pension of $20,000 a year. With inflation at 10%, your standard of living will be 40% lower after five years. Even with inflation at 4%, your standard of living will be 20% lower after five years.

Foreign Exchange Rates and Our Dollar

The value of our dollar relative to other currencies, especially the U.S. dollar (because of our large trading relationship with Americans), has an impact on many of our activities. For example, if our dollar is low compared to the U.S. dollar, American imports and U.S. travel will cost more. On the positive side, our low dollar will make our exports more attractive to U.S. buyers and make a Canadian vacation seem like a bargain to American tourists. But if our dollar is high relative to other currencies like the Mexican peso, Mexican imports and travel in Mexico may be a bargain for Canadian consumers.

You can find the current exchange rate between the Canadian dollar and many other currencies listed in the financial pages of daily newspapers.

What causes the Canadian dollar to change in value against other currencies?

There is no predetermined value for our dollar vis-a-vis other currencies. In essence, the Canadian dollar is just another commodity which can be bought or sold and, as such, is affected by the demand and supply of our currency. If more people want to buy the Canadian dollar than want to sell it, the value of the Canadian dollar will rise. If more people want to sell Canadian dollars than buy them, the value of our dollar will fall.

Our trade balance, government policies, political stability, the unemployment rate, interest rates, the national debt, our nation's productivity, the commodities we sell and inflation are key domestic forces that impact on our dollar. Just as critical is what's happening in other countries – which currencies and countries are attracting investment.

The Bank of Canada sometimes uses the Bank Rate to moderate movements in the exchange rate and the subsequent effect on the demand for Canadian products and services. For instance, an interest rate hike can help boost the value of our dollar by attracting investments in Canadian dollars.

Tip:

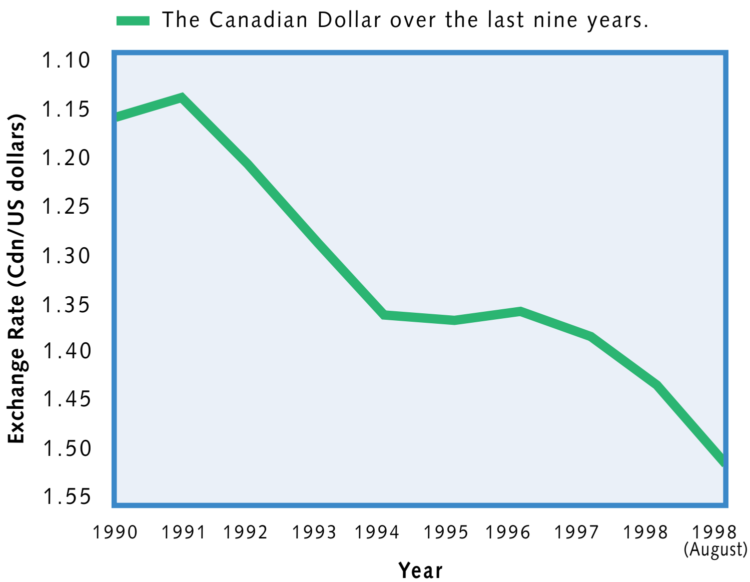
In deciding what products and services to buy and even where to take a trip, consider how far your dollar will go.

Lack of confidence in Asia led to falling stock markets in Asian countries. This, in turn, led to speculation that there would be a lower Asian demand for commodities (i.e. natural resources), causing world commodity prices to tumble. Currency traders then quickly dumped currencies of major commodity exporters like Canada and Australia. In the meantime, the United States benefited as investors uncertain about the rest of the world economy moved their money into U.S. dollar assets (which are perceived as "safer"), creating a stronger currency. In addition, Canada's lower interest rates caused investors to sell Canadian dollar investments to buy U.S. dollar investments.

How does a changing Canadian dollar affect my lifestyle?

If our dollar decreases in value, imported products become more expensive, hurting consumers (who buy goods made outside of Canada) as well as importers. A U.S. vacation costs you more, because it takes more Canadian dollars to purchase U.S. dollars. Local manufacturers will be better able to compete with costly foreign imports, as their prices will seem cheaper by comparison. Our border cities may also benefit by attracting American shoppers whose dollars will go much further than at home.

If our dollar increases in value, imported products become cheaper, a benefit if you are buying or selling them. On the other hand, if you are exporting to another country, the higher Canadian dollar will cause Canadian products to be more expensive in the foreign country, causing sales to decline.



Source: Statistics Canada

Our Saving and Spending Patterns

All of our activities, whether they involve spending, borrowing or saving, play a significant role in the economy.

Whether we spend our money or save it for a rainy day depends on a number of factors. These include our confidence in the economy and the future, our income and employment situation, interest rates, trends, age and lifestyle.

If we feel financially secure and believe our economy will continue to be strong, we are more inclined to spend money. When consumer confidence is high, sales of big ticket items like cars, furniture, appliances and electronic equipment increase. This is why consumer confidence levels are closely-watched economic barometers.

The demographic profile of society is important because it helps determine the tastes and consumption patterns of different people. This information can be used to predict the future demand for products and services.

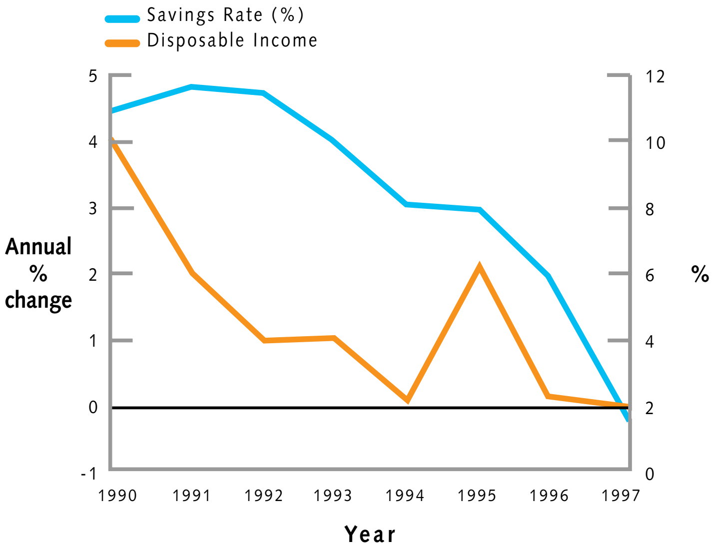
Research has shown a correlation between age and spending patterns. As we age, our concerns, tastes and lifestyles change, affecting how we spend. An aging population, for instance, may increase the demand for health care services, golfing and leisure travel, but reduce the demand for hockey, football and skiing.

The general level of savings in the economy is important because what one person saves, another person borrows to either spend or invest. If Canadians save too little, there may not be enough money available within Canada to fuel new growth and investment. Of course, Canada can always borrow from abroad when our domestic savings are too low.

Much like consumers, what businesses do is a telltale sign of the economy's health. Business confidence is just as important as consumer confidence. Businesses increase or curtail their spending in much the same way as consumers. If interest rates are high, they may put off investments or expansion. But when the cost of borrowing is low, businesses tend to invest in their enterprises, which ultimately strengthens the economy.

Whether a business is small or large – from a neighbourhood convenience store to a large corporation – it plays a role in providing employment, products and services. When companies are growing, this usually means job growth. This, in turn, means a higher rate of employment, increased consumer confidence, and ultimately, more spending. It makes sense to continually gauge the marketplace to assess what and how businesses and industries are doing.

Savings and Per Capita Disposable Income

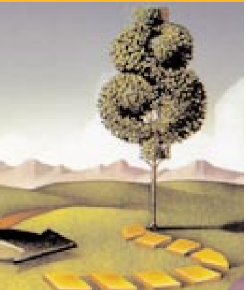


Source: Statistics Canada

The Financial Markets

Financial markets – stock, bond and money markets – are where individuals, companies and governments buy and sell investments. Changes in these affect everyone. A change in the stock market may affect a company's decision to expand and hire more employees or borrow money to invest in new equipment.

From investors' perspectives, their personal wealth will vary as the markets change. A rising stock and bond market typically means an increase in the value of personal investments. This, in turn, increases our confidence levels and fuels spending.



In the event of a sharp drop in the markets (and value of our assets), we would likely scale back our spending in response. Money market and bond market changes also have an impact on the interest rates we pay to borrow money or acquire a mortgage.

All markets are interconnected. If interest rates rise, stock prices will usually fall because other investments (those that earn interest) now become more attractive. When interest rates fall, stock prices often rise, something we have seen throughout much of the 1990s.

Even those who don't own stocks can be affected by the stock market. Almost everybody with a pension plan is indirectly affected by the stock market, as some proportion of their pension fund assets will be invested in the stock market. The stock market is also a barometer of confidence in the future. When confidence is high, the stock market tends to rise, increasing the wealth of those with funds invested in the market. As wealth rises, so does consumption, causing the economy to expand. Historically, stock market price declines have preceded recessions. This is why stock markets are also regarded as leading indicators of future economic activity.

The Bank of Canada s Policy

Many people are unaware of the Bank of Canada's role in the financial lives of Canadians. Its actions have considerable influence on interest rates, the value of the Canadian dollar on foreign exchange markets and overall economic activity. Unlike the chartered banks, which operate as commercial enterprises, Canada's central bank does not take deposits from, or make loans to, the public. The Bank of Canada sets monetary policy, acts as a banker to financial institutions and the federal government, manages the national debt on behalf of the government and issues bank notes. The Bank of Canada is also responsible for protecting the value of the dollar from being eroded by inflation. Since 1991, the Bank of Canada and the Government of Canada have set explicit targets for inflation. The current target range is 1% - 3% per year.

What is monetary policy?

Monetary policy refers to the control of the Bank of Canada on short-term interest rates and the money supply.

There is a direct relationship between the amount of money in circulation and consumer and business activity. If the Bank of Canada wants to provide a boost to the economy, one way is to influence the direction of short-term interest rates. By pushing short-term interest rates down, the Bank of Canada will induce more people to borrow money to either spend or invest. For example, as interest rates fall, more people may decide to buy a house. This results in more work for builders, painters, furniture retailers and so on. If the Bank wants to control inflation, it will raise interest rates to slow economic growth, thereby creating less demand and hence reducing inflationary pressures.

Because of their broad influence on the economy, the actions of the Bank of Canada are closely watched by many observers. The setting of the Bank Rate is especially important. An increase in the Bank Rate tells us the Bank of Canada intends to "tighten" the money supply (thus making borrowing more costly in order to curtail spending and business investment). A rate decrease indicates an intention to increase the money supply (by making borrowing less costly in order to stimulate spending and business investment). In determining monetary policy, the Bank monitors the performance of the economy,looking at such indicators as employment, inflation and exchange rates.

The Bank of Canada has some excellent publications and a web site, should you wish to find out more see page 28.

Government s Role

Governments are major players in the economy through their actions and fiscal policies. Yearly spending, taxation, transferring and borrowing activities are all part of government "fiscal policies."

These policies, in turn, influence decisions by consumers, businesses, savers and investors. Government tax policy, for instance, affects how much money we have to spend. If governments raise taxes, our disposable income is reduced. The initial result may be a slowdown in economic activity, although the net result depends on how the government uses the tax dollars it has raised. Potential changes to tax laws are a main reason government budget announcements are keenly-watched events.

How do government deficits and debts play a role?

A "deficit" occurs when a government spends more than it collects in revenues over the course of a year. The government can finance a deficit by raising taxes or by borrowing from Canadians, foreigners or the Bank of Canada. Deficits are significant because they influence a government's debt.

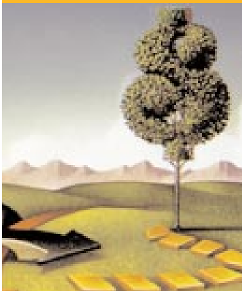
The "debt" is the total sum of all deficits, less all surpluses, over time. From a taxpayer's perspective, large government debts, which incur interest costs and have to be paid back, use up revenue that could be spent on programs that would benefit us today. It can also mean higher taxes for future generations.

In the 1996-97 budget year, 31.9% of each federal tax dollar was allocated to paying the interest costs on the federal debt. This is down from a peak of 36% in the 1995-96 budget year. At the end of 1997, the net federal government debt totalled $583 billion. From a historical standpoint, the federal debt was $932 per person in 1971 compared to $19,285 per person in 1997.

Global Forces

"Things were much simpler back then…" If you've heard this from an older friend or relative, the truth is, they're right. Not so long ago the Canadian economy was a much simpler place.

Today, international trade has become essential for most nations' survival. As trade, money flow and communications



increase among nations, countries are becoming more interdependent. This process is known as globalization.

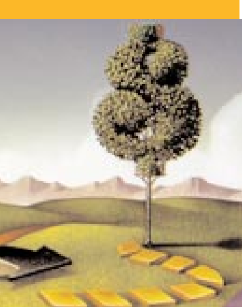
Advances in telecommunications and the lowering of trade barriers have promoted global competition and made globalization more than a trend. It is a fact of life.

Because of globalization, we are affected by virtually everything that happens around the world. In fact, the world is often referred to as “a global village.” That’s why being aware of what’s going on in other countries is essential for Canadians. Understanding global developments and how they affect us can help us make better sense of economic events happening at home. In fact, many economic shifts today are the direct result of events occurring in other parts of the world. It doesn’t take long for changes in trade and investment patterns to filter from one country to the next. For instance, the recent economic crisis in Asia has had an adverse effect on the economies of many countries including Canada.

You don’t have to look far to see the real impact of globalization in your everyday life. Perhaps your stereo comes from Japan, your car from Korea, the kids’ toys are manufactured in India, the sugar on your table comes from Trinidad, and that bottle of wine could be from Australia.

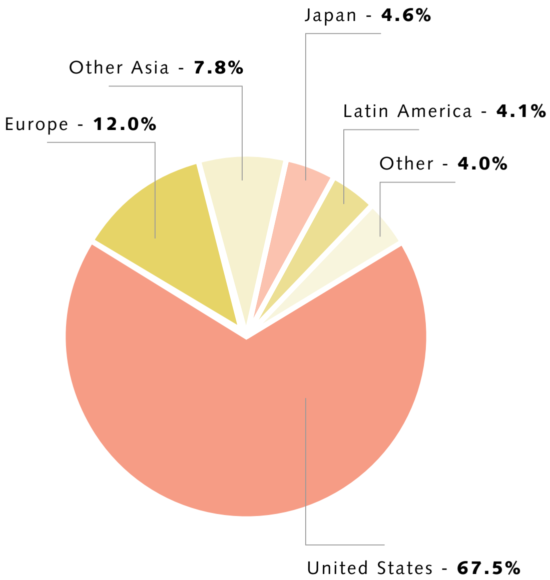
For some businesses, globalization has been a true friend. It has opened up new markets, allowing them to expand and hire more people. Others have not been able to compete effectively and have been forced to downsize or even close operations due to the competition from producers in other countries.

When talking about companies that have embraced globalization, the role of technology is usually at the forefront. This may mean cutting-edge technology that improves the product, efficient tracking systems, or state-of-the-art inventory control. Or it could mean having the right “knowledge-based workers.” A typical question that must be addressed by both businesses and countries today is

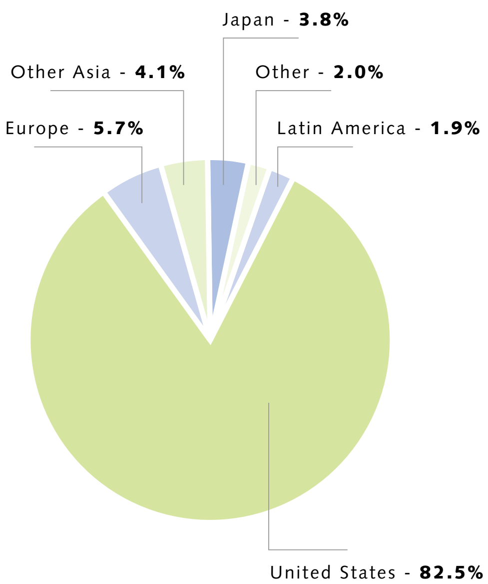


Canadian Trade

1997 Imports



1997 Exports



Source: Scotiabank,
Global Economic Outlook, January 1998.

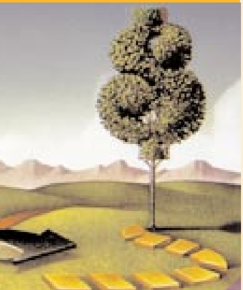
"Do you have the skilled workforce to get the job done?" The days of ranking the strength of a nation solely on their natural resources (coal, iron ore, and lumber) are gone.

For Canada, U.S. economic performance is particularly relevant. Because much of our trade occurs with our American neighbour, the economic health of Canada is inevitably linked to the U.S. (see pie charts on page 19). In fact, Canada and the U.S. share the largest bilateral trade relationship on the planet. When the American economy turns down, their demand for our exports falls, ultimately slowing down our growth. It is often said that when the U.S. sneezes, Canada catches a cold.

Global Competitiveness Touches Us All

"The economic welfare of our nation is significantly affected by the degree to which those in other nations buy our products and services, invest in our country and lend us funds as we require them. When we sell products and services to other nations, jobs are created and incomes are earned. When investment comes to Canada, businesses expand and improve, technology is developed and applied and jobs can be created. When we need to borrow, as many of our governments do, our ability to do so and the interest rate we have to pay will depend on the confidence foreign lenders have in our economy."

Source: Canadian Foundation for Economic Education, *The Canadian Economy; The Big Picture.*



Upturns and Downturns

The economy is fluid – always on the move and never standing still. Each day there's more information to learn, new trends, emerging markets, fluctuating interest rates, elections, new laws, and even snowstorms.

Every economy experiences alternating periods of good and bad times. A period of economic growth, known as a boom, is typically associated with accelerating inflation. Low inflation is meant to avoid a boom or bust. A more localized boom may result from the discovery of new natural resources (such as oil in Alberta and Newfoundland or gold in the Yukon) or high prices for our exports (such as wheat from Saskatchewan, lumber from British Columbia or cars from Ontario). Even a change in government or legislation can act to encourage investment and job opportunities.

An economic downturn can also be traced to many causes. For instance, it may be due to the price increase of a critical commodity, such as oil in 1973 and 1979. It could also be the result of an overheated economy. An overheated economy could cause a rise in interest rates, such as in 1981 and 1990. Localized downturns can result from the depletion of an important resource (such as cod in Atlantic Canada during the 1990s), the fall in price of a resource (such as oil in Alberta in 1986), or a natural disaster (e.g., Manitoba floods in 1997 and ice storms in eastern Canada in 1998).

A downturn is declared a recession when economic activity (real Gross Domestic Product or the total domestic output of products and services) declines consecutively for six months or more.

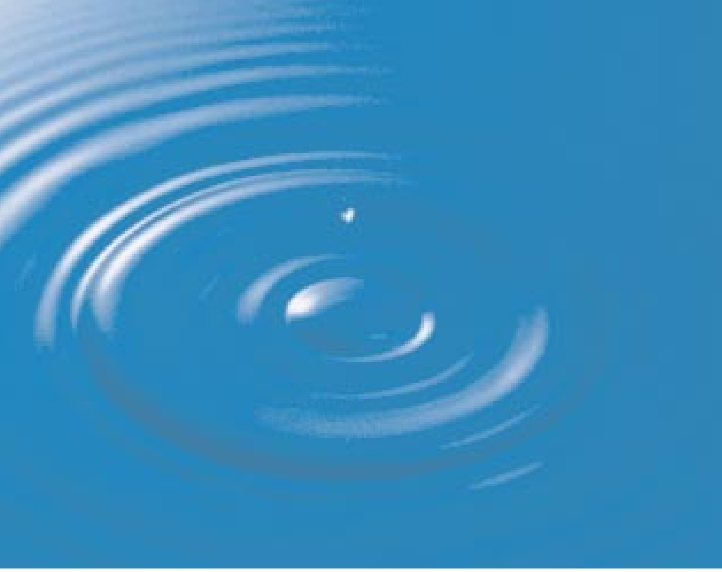
Consider the direction of the economy when making short- and long-term financial plans. If you are planning to buy a house, take a major trip, start or expand a business, or even figure out how much to budget or save, it's wise to keep a close eye on the economy. Needless to say, this isn't always easy. While we can make some educated guesses on where our economy is going, even the experts can't always predict what's around the corner.

Major Canadian Economic Indicators

Indicators provide a sense of where the economy has been and where it appears to be going. Monthly, quarterly and yearly performance figures are often gauged and compared. Such figures are reported in various ways in the news. For illustrative purposes, here is a typical list.

(annual per cent change unless otherwise indicated)	1997	1996
Real GDP	3.7	1.2
Exports	8.0	5.7
Imports	13.3	5.2
Consumer Spending	4.1	2.4
Residential construction	13.1	10.9
Business Investment (non-residential structures and equipment)	14.5	4.2
Housing Starts (000's)	147	125
Motor Vehicle Sales (millions)	1.42	1.20
Employment Growth	1.9	1.3
Unemployment Rate (%)	9.2	9.7
Prime Rate (average)	4.96	6.06
Canadian Dollar (in U.S. cents)	72.24	73.34
Personal Savings Rate (%)	1.7	5.8
Consumer Price Inflation	1.6	1.6

Sources: Statistics Canada, Department of Finance, TD Economics



Taking the Economy's Pulse

How can we tell how our economy is doing? There are a number of statistical measurements – also known as economic indicators – that measure the health of our economy.

Keep in mind that economics isn't an exact science and economists often disagree even when analyzing the same information. This makes it difficult to predict what's coming next. Nevertheless, looking at several economic indicators together can paint a reasonably clear picture of the economy's condition. More important, they can help us see trends and anticipate changes in direction.

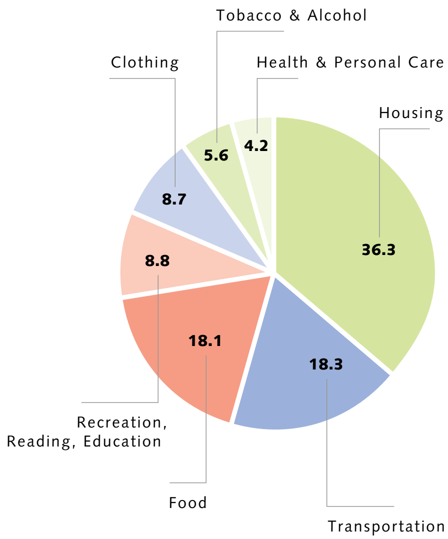
Four major indicators that are closely watched by economists, politicians, business leaders and consumers are Gross Domestic Product (or GDP), the rate of inflation, unemployment/employment rates and The Bank of Canada Rate.

- The GDP is a broad measure of what our economy produces in a year. It is the total value of all products and services produced in Canada for domestic consumption or export. It tells us whether our total output is rising, staying constant or falling. In other words, whether the economy is growing or not. Economists also look at per capita real GDP, which is the GDP adjusted for changes in the population and the cost of living.

• The Consumer Price Index (CPI) is another important indicator, measuring the rate of inflation by monitoring the average change in the price of about 400 different products and services bought by Canadians. As prices change, consumers vary their spending patterns. When prices on average rise, households are likely to avoid high-priced items. The CPI is also used to determine increases in social assistance payments and old age security payments. It guides government budgets and acts as a reference point in private-sector wage negotiations. Financial markets monitor the CPI as a main indicator of inflation, which in turn, will affect interest rates.

The index itself measures the average change in prices paid by consumers in different cities across Canada for a "basket" of hundreds of different products and services. These include items such as food, clothing, alcohol, tobacco, hair cuts, medical fees, etc. CPI figures are compared against a base period to measure how much the cost of living has changed since the last base period. A rise in the CPI indicates inflation and the erosion of the average consumer's purchasing power.

Percentage Weights of the CPI



Source: Statistics Canada

- Another statistic used to measure the state of the economy is the unemployment rate. By knowing what percentage of our population is employed, we can determine spending patterns. If employment is high, people have more money to spend, consumption rises and the economy expands. When employment is low, consumption falls and the economy contracts.

  Each month Statistics Canada conducts a random survey of Canadian households to determine who is employed. The employed are those over age 15, who have worked part-time or full-time during the month and those who had a job but did not work due to labour disputes, vacations, or illness. The unemployed include all those without work who are actively looking and available for work. By comparing unemployment rates from year to year, we can gain insight into how effectively our economy is working. The rate is also useful for government to target relief programs to those various regions and age groups most affected.

- Through the Bank Rate, the Bank of Canada influences the direction for all other short-term interest rates in the economy. It is an important indicator because it signals the monetary policy the Bank of Canada intends to pursue. For instance, increases in the Bank Rate typically mean the Bank wants to slow economic growth, whereas decreases in the rate signal an intention to stimulate economic activity.

Other frequently-watched indicators include:

Motor vehicle sales: Auto sales account for approximately one-fifth of all retail sales and represent a good measure of consumer spending activity. Auto sales are a leading indicator that rise when confidence is high and fall when confidence is low.

Housing starts: An important indicator, a housing start is the beginning of construction on a building. Although the construction of new housing accounts for a relatively small part of the overall economy, it provides spin-offs for other parts of the retail sector as homeowners furnish their new dwellings. The housing industry is also a good barometer of people's confidence in the future.

Canadian manufacturing orders: When manufacturing orders are rising, strong industrial production in the coming months is likely.

Merchandise trade balance: Since more than one-third of the Canadian economy is dependent on foreign trade, a strong merchandise trade balance tells us that exports are exceeding imports, which is a positive signal for the economy.

U.S. Indicators: Since so much of Canada's economy is tied directly or indirectly to the American economy, U.S. indicators are frequently published in most major Canadian newspapers. They include:

- Employment and labour market statistics
- Consumer price indexes
- GDP
- Interest rates and money supply data
- Consumer and business confidence indexes

The actions and policies of the U.S. Federal Reserve, the U.S. equivalent of The Bank of Canada, are also closely watched.

Tip:

Knowing how to interpret economic indicators can be useful for planning your own financial affairs and guiding your investment strategy.

In Closing

You don't need a degree in economics to understand how the economy affects your every day life. By simply following key developments in the economy and watching the upward or downward signs, you should be able to make more informed financial decisions. Stay on top of trends and read magazines and newspapers for financial planning and investment tips.

Although it may be difficult to accurately predict where the economy is headed, the trends, signals and other "big picture" factors discussed in this booklet can help you plan for the future.

We hope this booklet has given you a greater insight into our economy, and that it will inspire you to make your own observations.

Where to Find More Information

There are plenty of sources to help you keep informed of economic and financial conditions or to learn more about the economy.

- **Daily newspapers.** Newspapers cover economic developments, conditions and leading indicators such as interest rates, inflation and the Canadian dollar.

- **Magazines.** *Macleans, Canadian Business, Report on Business* and other magazines offer updates and analysis on the latest economic news. *I.E. Money*, a Canadian magazine, provides timely information on personal investing, money management and economic issues. To find out what's going on around the world, check out *The Economist*.

- **Chartered banks.** Most have web sites showing up-to-date lending and savings rates, as well as other leading indicators. Many sites contain excellent sections dealing specifically with economic indicators, issues and forecasts:

  - Bank of Montreal: www.bmo.com
  - Bank of Nova Scotia: www.scotiabank.ca
  - Canadian Imperial Bank of Commerce: www.cibc.com
  - Canadian Western Bank: www.cwbank.com
  - Hongkong Bank of Canada: www.hkbc.com
  - Laurentian Bank of Canada: www.laurentianbank.com
  - National Bank of Canada: www.nbc.ca
  - Royal Bank of Canada: www.royalbank.com
  - Toronto Dominion Bank: www.tdbank.ca

- **Industry Canada:** Look at their Strategis web site (http://strategis.ic.gc.ca) for a wealth of information on our economy.

- **Statistics Canada:** Their web site (www.statcan.ca) contains key monthly and quarterly measures of economic performance for Canada and each province, as well as annual data. Regional offices are listed in telephone directories.

- **Department of Finance:** The Department of Finance is the federal department responsible for providing the Government of Canada with analysis and advice on the broad economic and financial affairs of the country. They offer budget information and have a number of publications on economic topics. (Tel: 613-992-1573; Internet: www.fin.gc.ca)

- **Bank of Canada:** Offers publications on monetary and other economic issues. Its web site contains a wide range of information, including weekly financial statistics. www.bank-banque-canada.ca or call 1-800-303-1282.

- **The Canadian Foundation for Economic Education (CFEE)** is a non-profit educational organization that offers a range of publications and programs on economic topics, primarily for youth and educators but also for the general public. Call CFEE at 416-968-2236 or visit www.cfee.org.

- **Colleges and universities** offer courses and information through their economic/business departments.

- **The Internet.** There are various web sites offering economic and financial information, such as the CBC Newsworld site (www.newsworld.cbc.ca.) and CANOE's MoneyNews site (www.canoe.ca/MoneyNews).

- **Your local library or book store.**

Key Terms

Bank of Canada: Canada's central bank. The Bank of Canada formulates and implements monetary policy for Canada.

Bank Rate: The interest rate paid by major financial institutions if they borrow from the Bank of Canada. The Bank Rate influences the rates of interest major financial institutions charge and pay their customers.

Bull and Bear Markets: When stock prices are increasing and it's a healthy market, this is known as a bull market. When stock prices are decreasing, it's a bear market.

Business Cycle: The ups and downs of the economy that follow a cyclical pattern over the course of time.

Consumer Price Index: An index that measures movements in the average price of products and services typically consumed by Canadian families.

Deflation: An actual decline in the general level of prices in the economy.

Demographics: Characteristics of the population that influence consumption of products and services. They include age, sex, race, family size, level of education, occupation, income and location of residence.

Depression: A prolonged downturn in the economy and level of business activity.

Disinflation A reduction in the rate of inflation either as a result of government policy or of declining economic activity.

Economic Growth: The rate of change in output from one year to the next.

Economic Indicators: Statistics that help determine how the economy is faring. They include the Consumer Price Index, housing starts, and unemployment rates, among others.

Exports: Products and services produced in Canada and sold in other countries.

Fiscal Deficit: When the government spends more money than it receives in revenue over the course of one year.

Fiscal Policy: The use of government spending and taxation policies to influence the economy.

Fiscal Surplus: When the government receives more in revenue than it spends over the course of the year.

Foreign Exchange rate: The value of a nation's currency in terms of another nation's currency.

Gross Domestic Product: The total value of all the goods and services produced by the Canadian economy in a single year.

Gross National Product: The value of all goods and services accruing to Canadians in a given year. It equals Gross Domestic Product, plus income of Canadians from foreign production, less income from Canadian production earned by non-residents (such as interest and dividends paid to foreign lenders).

Imports: Goods and services produced in other countries and sold in Canada.

Inflation: A rise in the average level of prices in the economy.

Macroeconomics: Looking at the economy as a whole, particularly the interaction of its various components with one another.

Microeconomics: Looking at the individual parts of the economy, with emphasis given to the market process and how it works.

Monetary Policy: The ability of the Bank of Canada to influence the economy through changes in short-term interest rates and the money supply.

Personal Disposable Income: Personal income minus personal income tax payments. Also called "take-home pay."

Personal Consumption Spending: What households collectively spend on goods and services.

Personal Savings: The difference between personal disposable income and personal consumption spending.

Prime lending rate: The rate of interest charged on loans by chartered banks to their most creditworthy customers.

Recession: When the Gross Domestic Product declines for at least two consecutive three-month periods.

Seasonal Unemployment: The loss of jobs due to changes in the climate and other conditions. Forestry, fishing and construction are affected by climate, while retailing is affected by seasons and holidays. For instance, at Christmas, retail employment is higher than in January.

Stagflation: A period of time in which both the unemployment rate and the rate of inflation are relatively high.

Unemployment rate: The percentage of the labour force that is not employed but currently seeking work.

As part of the program Building a Better Understanding, we are offering a free series of publications, ranging from money management and interest rates to mortgages, starting a small business and saving for your children's education. To obtain copies, call toll-free 1-800-263-0231 or visit our web site at www.cba.ca.

The Canadian Bankers Association, established in 1891, is a professional industry association that provides its members – the chartered banks of Canada – with information, research and operational support, and contributes to the development of public policy on issues that affect financial services. The CBA also provides information to the public on industry and financial issues.

CANADIAN BANKERS ASSOCIATION

Building a Better Understanding