

2002-2003
BUDGET

Budget

Plan

November 1, 2001

The Budget Plan 2002-2003

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Section 1

Economic Situation Since the Beginning of 2001 and Revised Outlook for 2001 and 2002

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Economic Situation Since the Beginning of 2001 and Revised Outlook for 2001 and 2002

A number of events have affected the economic situation since the 2001-2002 Budget was tabled, the most important one being the tragic terrorist attacks on New York and Washington on September 11. This section reviews the current economic situation in Québec in the light of these new factors and the information available in mid-October 2001. It also presents the revised economic forecasts for 2001 and 2002 since the last Budget and compares them with private-sector forecasts.

Economic situation since the beginning of 2001

More severe economic slowdown than anticipated in the United States in 2001

It was predicted by the majority of experts that the U.S. economy, after a steady annual rate of growth of over 4% from 1997 to 2000, would grow more slowly in 2001. When the last budget was prepared, private-sector forecasters projected an average growth of about 2% in the U.S. economy in 2001, the same rate used to prepare the economic outlook for Québec in last March's budget.

The slowdown in the U.S. economy was anticipated because of several factors, notably:

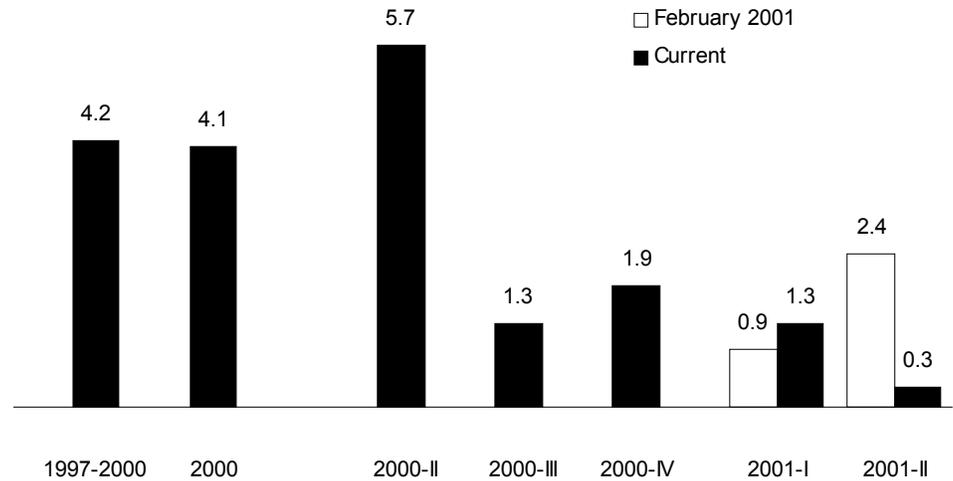
- considerable monetary tightening by the U.S. Federal Reserve in 2000: hike in interest rates – federal funds – from 4.75% in June 1999 to 6.50% in May 2000, where they stayed until December 2000;
- the continually high cost of energy, which would reduce households' purchasing power and businesses' profit margins: the price of oil rose from US\$18 in 1999 to US\$28 in 2000;
- the major downturn in stock markets, which would curb business investment and household consumption: between mid-March 2000 and February 2001, the Nasdaq (market index consisting primarily of technology issues) fell by 57% and the S&P 500 (market index of the 500 largest U.S. corporations) declined by 7%;
- the projected continued decline in automobile sales in the United States, given the renewal of the vehicle fleet in recent years: forecasters anticipated a decrease of approximately 8% in the number of vehicles sold in 2001.

Not only did the predicted slowdown occur, but it was also slightly more severe than expected during the first eight months of 2001.

GRAPH 1.1

MORE SEVERE ECONOMIC SLOWDOWN THAN ANTICIPATED IN THE UNITED STATES IN 2001

(real GDP, percentage change at annual rate)



Source: DRI-WEFA.

After reaching an annual rate of 5.7% in the second quarter of 2000, real GDP growth never again exceeded 2%: it was 1.3% and 1.9%, respectively, in the third and fourth quarters of 2000, and 1.3% and 0.3%, respectively, in the first and second quarters of 2001.

However, it was not until the second quarter of 2001 and during the summer that the U.S. economy really started to show signs that the slowdown would be worse than predicted.

Principal factors

A number of factors combined to exacerbate the economic slowdown in the United States in 2001.

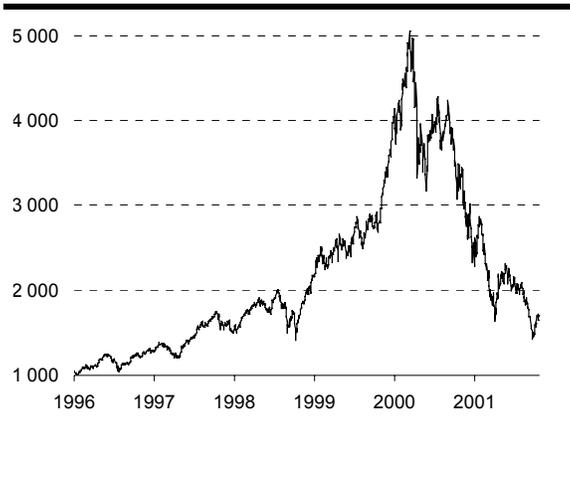
- **Stronger downturn in stock markets**

Stock markets have continued to plunge since the beginning of the year, even more so than predicted. This downturn primarily reflects a downward adjustment in profit outlooks and excess investment in certain economic sectors in recent years. Between January 30 and September 10, 2001, the Nasdaq market index fell by 40% (from 2838 to 1695) while the S&P 500 dropped by over 20% (from 1374 to 1093). These decreases are in addition to those observed in 2000. Hence, the speculative bubble in high-technology stocks, observed in the late 1990s, rapidly burst.

The drop in stock market prices led to a major restructuring of the information technologies and communications sector, and forced businesses to abandon or delay certain capital projects. Similarly, by reducing household wealth, the stock market correction affected household confidence and planned spending.

GRAPH 1.2

BURSTING OF THE SPECULATIVE BUBBLE IN TECHNOLOGY STOCKS
(Nasdaq Index)



Source: Bloomberg.

GRAPH 1.3

MAJOR DOWNTURN IN S&P 500
(S&P 500 Index)



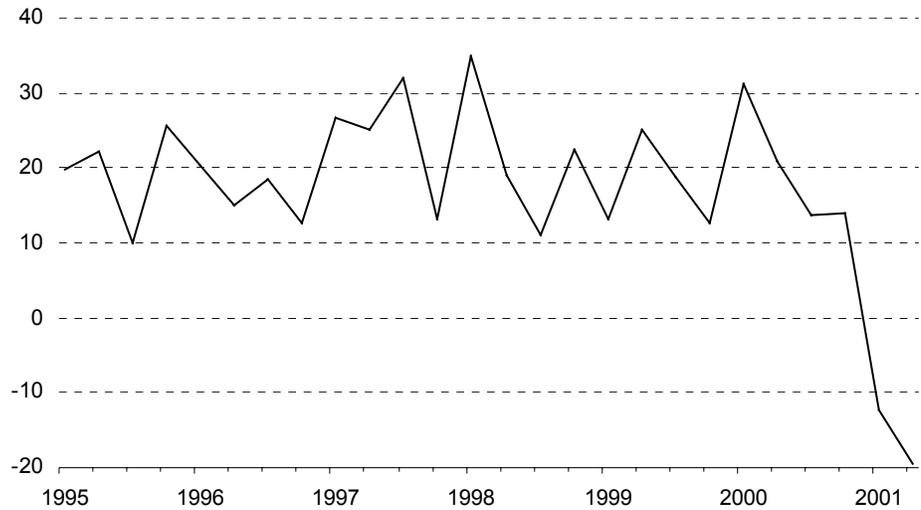
Source: Bloomberg.

▪ **Decline in demand for computer and telecommunications equipment**

Faced with flagging demand, lower profits, more difficult access to corporate financing and excess inventory, U.S. companies have cut back spending on computer and telecommunications equipment substantially since the beginning of the year. After increasing at an average annual rate of nearly 20% since 1995, demand for such products fell by 12.4% and 19.5% in the first and second quarters of 2001, respectively.

GRAPH 1.4

SHARP DECLINE IN COMPUTER AND TELECOMMUNICATIONS EQUIPMENT SPENDING IN THE UNITED STATES
(percentage change at annual rate)



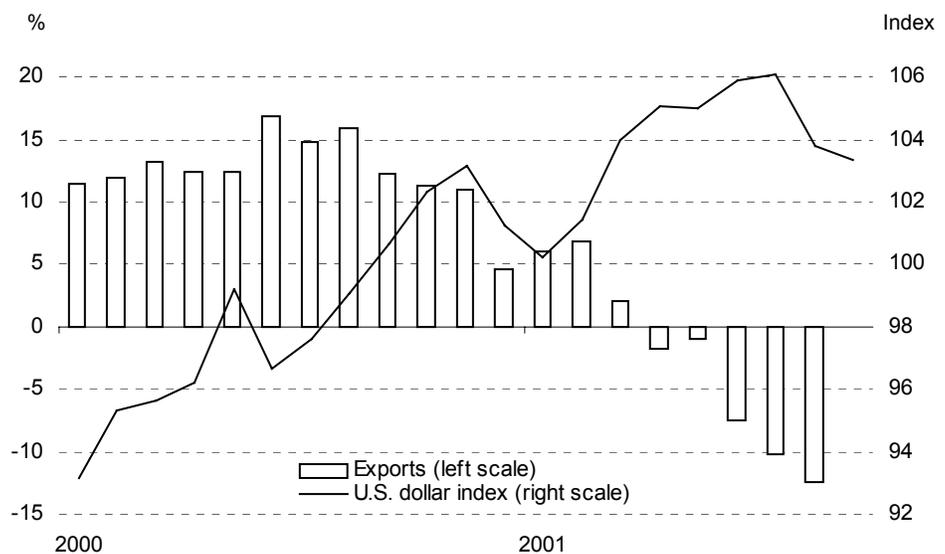
Source: U.S. Bureau of Economic Analysis.

▪ **Strong U.S. currency**

Despite the slowdown in economic growth, the U.S. dollar rose nearly 6% in value between January and July 2001 relative to the currencies of the country’s main trading partners. This increase is attributable to a substantial inflow of foreign capital owing to the role of the American dollar as a safe haven and the favourable medium-term economic outlook in the United States. The strong American dollar contributed to a nearly 13% decline in U.S. exports between August 2000 and August 2001.

GRAPH 1.5

APPRECIATION OF THE U.S. DOLLAR CONTRIBUTED TO THE DECLINE IN U.S. EXPORTS
(percentage change and index)



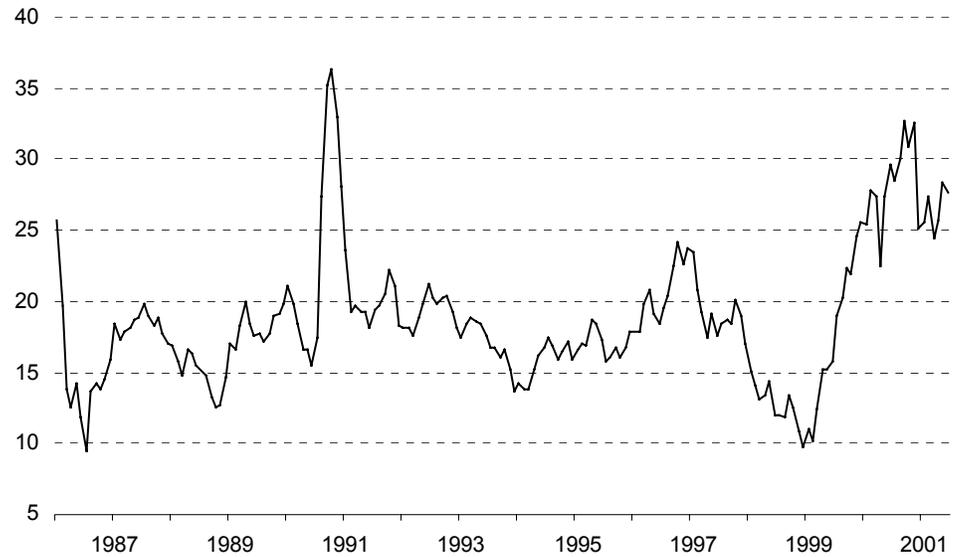
Source: DRI-WEFA.

▪ **Higher energy and food prices**

The higher-than-expected energy and food prices in the first half of 2001 reduced households’ purchasing power and, as concerns energy prices, businesses’ profit margins.

The price of oil remained relatively high during the first six months of 2001, averaging nearly US\$27, a sharp increase over the average price observed during the past 15 years (US\$18.5). The price thus remained at the top of the OPEC target band (between US\$22 and US\$28).

GRAPH 1.6

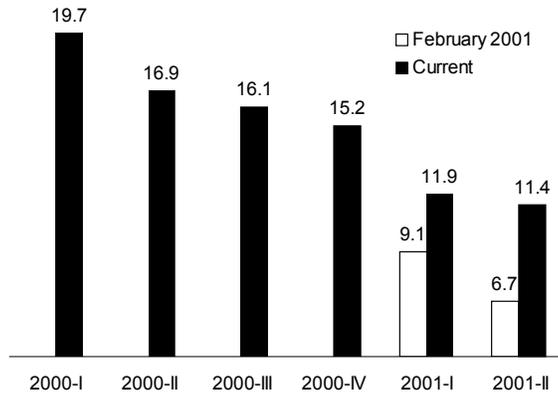
**PRICE OF OIL REMAINED HIGH
IN THE FIRST HALF OF 2001**
(US\$/barrel)

Source: Bloomberg.

The price of gas was not only affected by the high price of oil, but it was also under greater pressure from a low inventory level and temporary reduction in refining capacity due, in particular, to major fires at refineries in the United States. Oil refineries also concentrated on producing other, more profitable products, such as fuel oil, during this period. A sharp increase was also observed in the price of natural gas, due mainly to considerable construction of new houses using this form of energy. Lastly, the energy crisis in California, which was primarily the result of poor deregulation planning, led to an increase in electricity prices in that region.

GRAPH 1.7

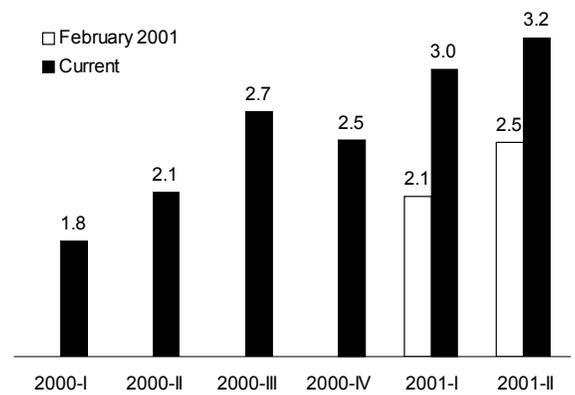
DROP IN U.S. ENERGY PRICES SLOWER THAN PREDICTED
(annual percentage change)



Source: DRI-WEFA.

GRAPH 1.8

SHARP INCREASE IN U.S. FOOD PRICES
(annual percentage change)



Source: DRI-WEFA.

The price of food products rose more than expected, due to various factors that affected supply. Fruit and vegetable prices were affected by adverse climatic conditions in the southwestern United States, while meat and related products suffered from the lower supply on international markets following epizootic diseases in Europe.

Slowdown aggravated by the terrorist attacks in the United States

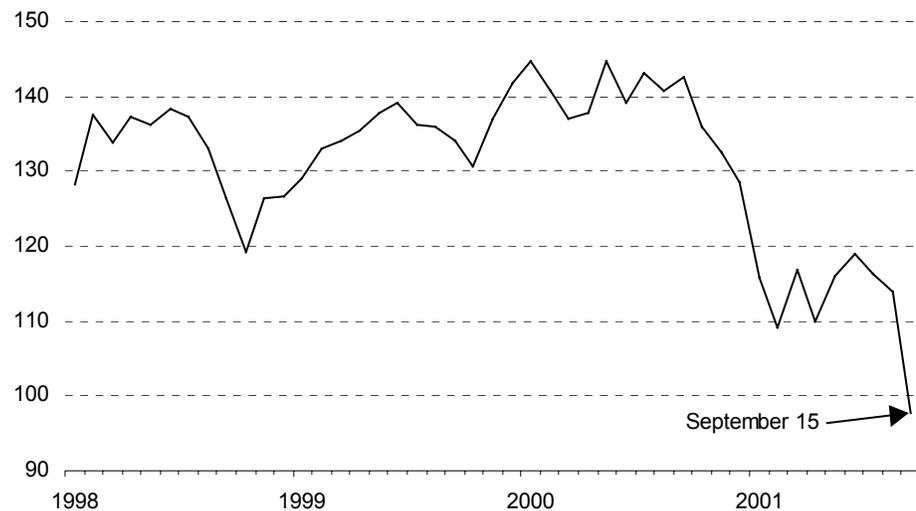
The terrorist attacks on September 11, 2001 exacerbated an already slowing U.S. economy. In the short term, in addition to severely slowing down economic and financial activity in one of the United States' largest cities, the attacks led to:

- significant declines in activity in the air transportation, aeronautics, tourism and financial sectors, which in turn resulted in major layoffs;
- a loss of confidence on the part of economic agents owing to the uncertainty created by the attacks.

However, a significant erosion of household confidence had already begun in the United States even before the events of September 11. The household confidence index, compiled by the Conference Board, dropped 21% between May 2000 and August 2001, primarily due to the deterioration in the job market – nearly 500 000 jobs lost in the last six months – and stock markets. An additional 15% decline was observed in September following the attacks.

GRAPH 1.9

CONSUMER CONFIDENCE (Conference Board Index)



Source: DRI-WEFA.

Reaction of U.S. authorities

U.S. authorities nevertheless moved quickly to revive the economy and mitigate the effects of the terrorist attacks. Several measures were put forward after September 11.

First, additional liquidity was injected into the banking system to ensure its smooth operation. Then, the federal funds interest rate was cut by 100 basis points (-50 points on September 17 and -50 points on October 2), to 2.5%, for a total reduction of 400 points in short-term interest rates in the United States since the beginning of the year.

The U.S. government also set up a number of emergency funds, the first one consisting of US\$40 billion to aid victims of the attack, shore up security and clean up and restore damaged sites. It subsequently announced a US\$15-billion aid package to help the airlines.

Lastly, the U.S. government undertook to implement an economic stimulus plan centred on tax cuts, at a cost of roughly US\$100 billion. These tax reductions would be in addition to the US\$55-billion cut in 2001 already implemented as part of the planned tax reduction of US\$1 350 billion over 11 years approved earlier this year.

Despite the U.S. authorities' swift response to the September 11 attacks, economic conditions have deteriorated quickly over the past few months,

requiring forecasters to revise the projected growth in the U.S. economy in 2001 downward.

Slowdown in the United States affects Québec

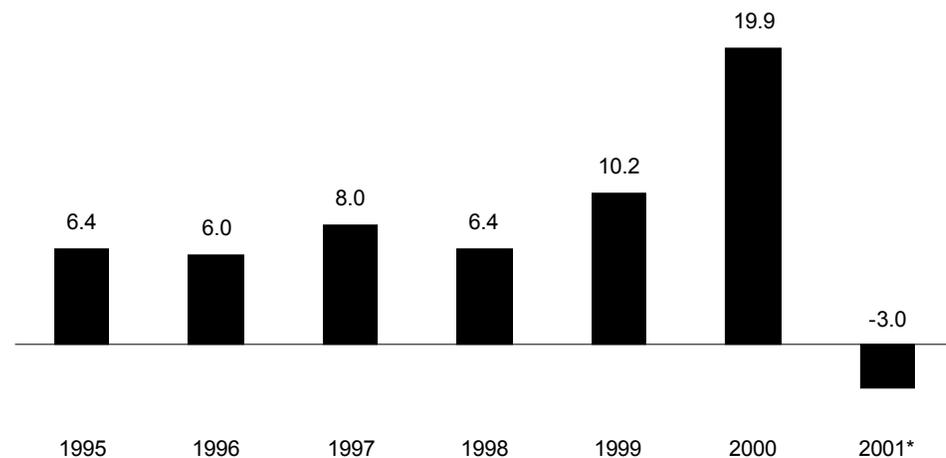
With over half of Québec's goods exports being destined for the United States, the Québec and U.S. economies are highly integrated. Québec has therefore been feeling the effects of the economic changes south of the border since the beginning of the year.

Downturn in international exports

After soaring nearly 20% last year, Québec's international exports of goods have been down an average of 3.0% since the beginning of the year, compared with the same period in 2000.

GRAPH 1.10

QUÉBEC'S INTERNATIONAL EXPORTS AFFECTED BY SLOWDOWN IN UNITED STATES (percentage change, in constant dollars)



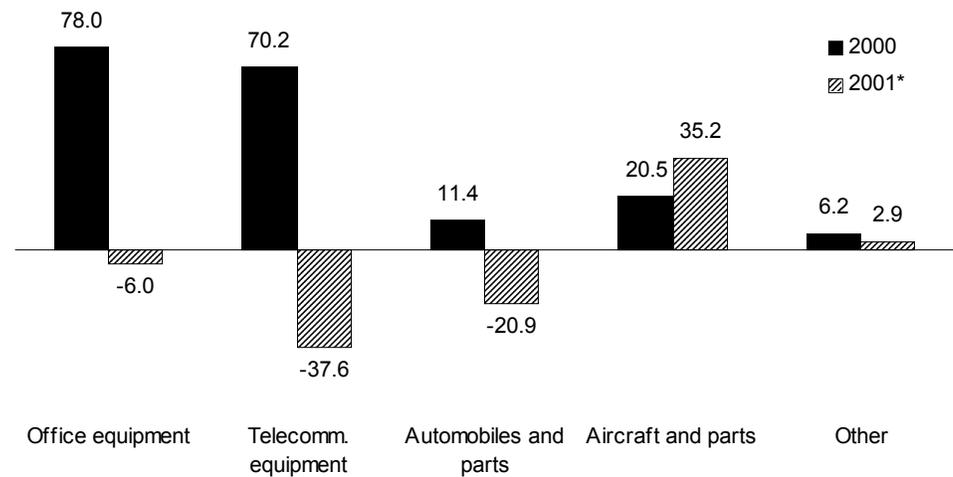
* Average for first seven months of 2001.

Source: Institut de la statistique du Québec.

Among the hardest-hit sectors are office and telecommunications equipment, down 6.0% and 37.6%, respectively, since the beginning of the year. Both sectors had posted strong growth in 2000. This year, they have been impacted by the marked downturn in investment in computer and telecommunications equipment in the United States. The automobile sector has also experienced a significant decline, dropping 20.9%. In contrast, the aeronautics sector was showing strong growth (35.2%) prior to the events of September 11, while the increase in other sectors was more subdued (2.9%).

GRAPH 1.11

DOWNTURN IN 2001 EXPORTS MAINLY IN OFFICE AND TELECOMMUNICATIONS EQUIPMENT
(percentage change, in constant dollars)



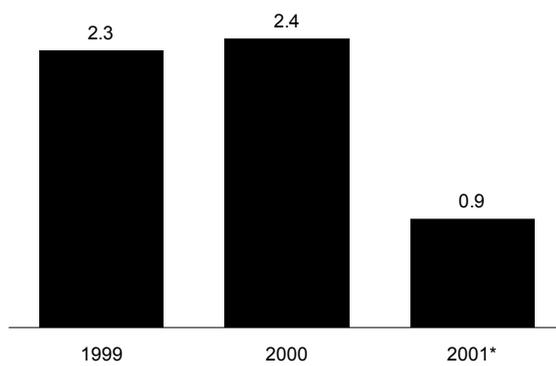
* Average for first seven months of 2001.
Source: Institut de la statistique du Québec.

Levelling off of labour market

The sag in exports had repercussions on the labour market. Employment continued to grow, but at a slower pace. After rising 2.4% in 2000, the growth in employment slowed to an average rate of 0.9% for the first three quarters of 2001 relative to the same period last year. Between December 2000 and September 2001, some 45 000 jobs were created in Québec, compared with 27 000 in Canada. Despite job increases, the unemployment rate was up, reaching an average of 8.6% since the beginning of the year (8.4% in September).

GRAPH 1.12

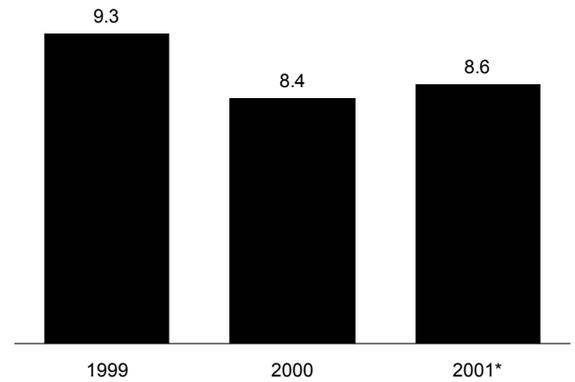
SLOWER EMPLOYMENT GROWTH
(percentage change)



* Average for first three quarters.
Source: Statistics Canada.

GRAPH 1.13

INCREASE IN UNEMPLOYMENT RATE
(in percent)



* Average for first three quarters.
Source: Statistics Canada.

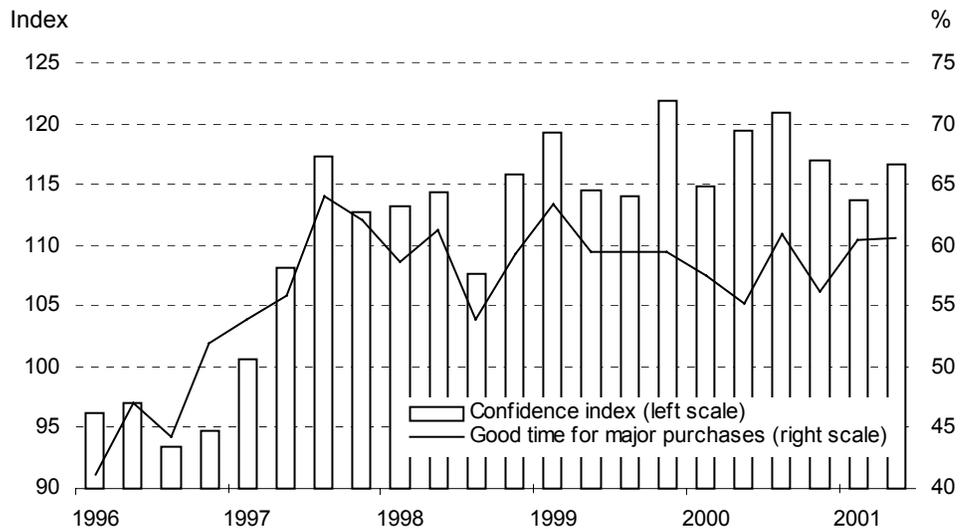
Domestic demand continues to climb

Household confidence still good before the attacks

Despite the slowdown, domestic demand continued to grow, with household confidence remaining relatively high before the September 11 terrorist attacks. With more purchasing power, mainly as a result of major personal income tax reductions, households have continued to spend more on consumer goods and housing since the beginning of the year.

GRAPH 1.14

QUÉBEC CONSUMER CONFIDENCE REMAINED HIGH BEFORE THE ATTACKS (index and response rate in percent)



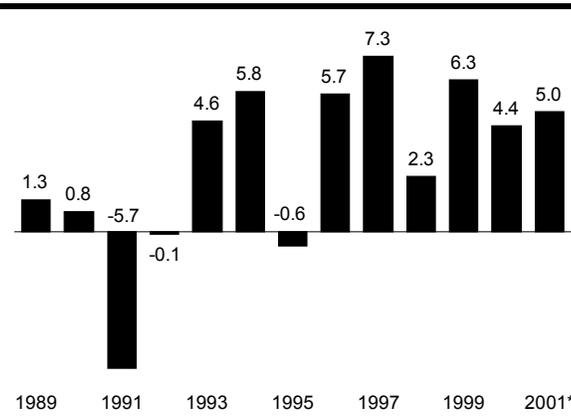
Source: Conference Board of Canada.

Good consumer spending growth

Retail sales continued to grow at a relatively high rate this year, reaching an average of 5.0% for the first eight months of 2001, compared with the same period last year. This is a higher increase than that recorded in 2000 (4.4%) and markedly stronger growth than recorded during previous economic slowdowns.

GRAPH 1.15

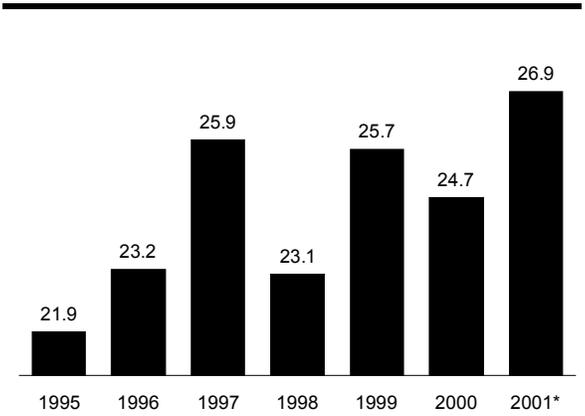
GOOD RETAIL SALES GROWTH
(percentage change)



* Average for first eight months of 2001.
Source: Statistics Canada.

GRAPH 1.16

INCREASE IN HOUSING STARTS
(thousands of units)



* Average for first nine months of 2001.
Source: Canada Mortgage and Housing Corporation.

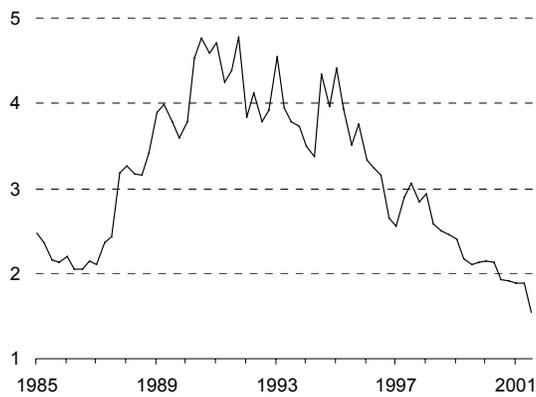
Increase in residential construction

Sparked by major mortgage rate cuts and low excess supply, housing starts rose sharply during the first months of 2001, reaching an average of 26 900 units from January to September, the highest level recorded in seven years.

Excess supply was massively absorbed in the housing sector, as witnessed by the currently low listing/sales ratio and rental housing vacancy rate. After peaking at 7.5% in 1992, the rental housing vacancy rate dropped to 2.2% in 2000.

GRAPH 1.17

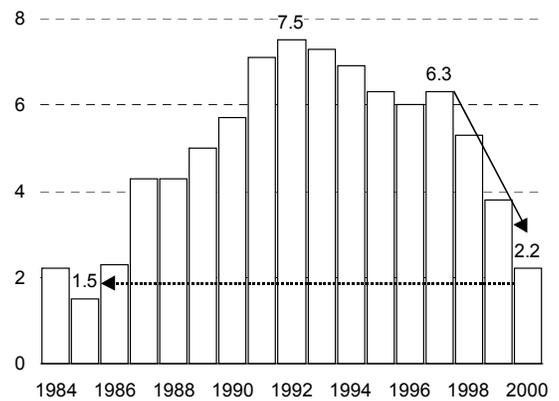
DROP IN LISTING/SALES RATIO
(ratio)



Source: Canadian Real Estate Association.

GRAPH 1.18

RENTAL HOUSING VACANCY RATE IN QUÉBEC
(in percent)



Sources: Canada Mortgage and Housing Corporation and ministère des Finances du Québec.

TABLE 1.1

PRINCIPAL ECONOMIC INDICATORS – QUÉBEC AND CANADA

	Last period available	Percentage change	
		2000	2001 ¹
CANADA			
— Real GDP	2nd quar.	4.4	2.3
— Consumer prices	September	2.7	3.0
QUÉBEC			
— Real GDP	2nd quar.	4.7	2.4
— Nominal GDP	2nd quar.	6.2	3.8
— Exports (1997 \$) ²	July	19.9	-3.0
— Retail sales	August	4.4	5.0
— Wages and salaries	June	6.5	4.0
— Housing starts	September	-4.1	7.6
— Housing resales	August	8.0	12.4
— Non-residential investment ³	July	6.1	-0.9 ⁴
— Manufacturing shipments	August	13.5	-1.7
— Employment	September	2.4	0.9
— Unemployment rate ⁵	September	8.4	8.6

1 Average for available months in 2001, compared with same period in 2000.

2 On customs basis.

3 Statistics Canada, Private and public investment, July 2001.

4 Decrease owing to the completion of two major investment projects: the Alcan project in Alma and the Magnola project in Asbestos. Notwithstanding these two projects, non-residential investment should grow around 4%.

5 Average level in percent (8.4% in September 2001).

Revised outlook for 2001 and 2002

2001-2002 Budget already predicted a slowdown

In the economic outlook presented in the 2001-2002 Budget, significantly slower economic growth was already predicted in Québec owing to the downturn in the United States. After four consecutive years of particularly robust growth, including a 4.7% increase in 2000, the rate was expected to slow to 2.7% in 2001 and 2.6% in 2002.

So far in 2001, the Québec economy has suffered from the deepening slowdown in the U.S. economy. Québec exports, in particular, have been greatly affected by the marked decline in investment in computer and telecommunications equipment in the United States. They will continue to be weakened between now and the end of the year by the drop in demand resulting from the September 11 attacks.

Short-term growth prospects weakened by the terrorist attacks

If not for the terrorist attacks in the United States, the Québec economy would probably have gotten stronger in the second half of 2001, and the economic outlook for 2002 would not have been much different from that presented in the 2001-2002 Budget. At the beginning of September, most economists still considered this the most likely scenario given the substantial reduction in short-term interest rates since January (-300 basis points in the United States and -175 points in Canada) and the fiscal and budgetary policies favourable to growth implemented through recent budgets. However, because of the September 11 attacks, the recovery forecasters initially expected to take place in the second half of 2001 will not occur until 2002.

In the space of a few weeks, the economic outlook changed considerably as a result of the terrorist attacks. It quickly became apparent that certain sectors had suffered more than others, notably air transportation, aeronautics and tourism. In addition, economic agents' confidence, which is crucial to undertaking projects and commitments in the medium term, was shaken, not only in the United States, but in the other major industrialized countries as well, owing to their strong economic interdependence.

Accounting for these impacts, private-sector forecasters revised their 2001 and 2002 growth prospects for the United States substantially downward between September and October 2001. They are now anticipating average growth of only 1% in 2001 and 1.2% in 2002, or respectively 0.6% and 1.5% below the assumptions prevailing in early September, just before the attacks. Since February of this year, projected economic growth in the United States has been lowered by 1% and 2.3% for 2001 and 2002, respectively.

TABLE 1.2

REVISED U.S. ECONOMIC FORECASTS
(real GDP, percentage change)

	2000*	2001	2002
February 2001	4.1	2.0	3.5
Before September 11	4.1	1.6	2.7
October 2001	4.1	1.0	1.2

* Observed.

Source: Consensus Economics.

The economic outlook for all of the major industrialized countries has also been revised significantly downward for 2001 and 2002. On average, projected growth for the G-7 countries has been lowered by about one percentage point for 2001 and two percentage points for 2002 since February.

TABLE 1.3

ECONOMIC OUTLOOK FOR G-7 COUNTRIES
(real GDP, percentage change)

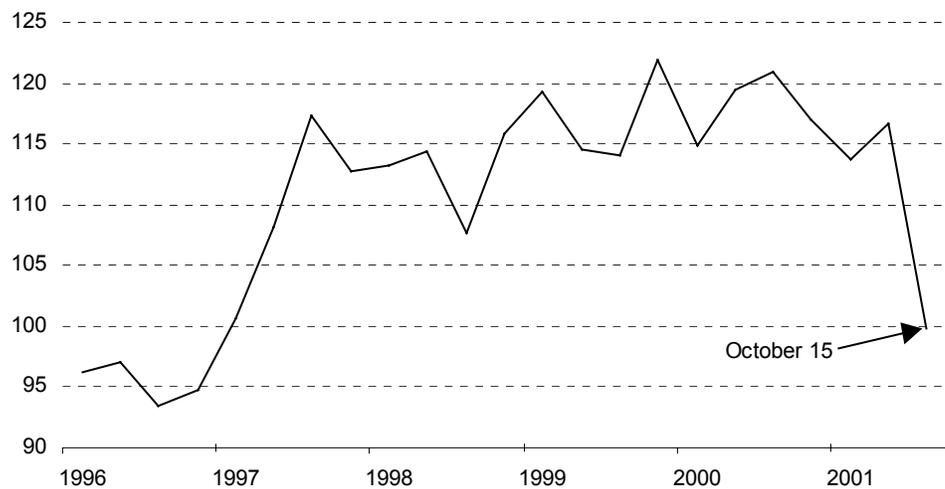
	2001			2002		
	February	October	Revision	February	October	Revision
United States	2.0	1.0	-1.0	3.5	1.2	-2.3
Canada	2.7	1.4	-1.3	3.4	1.7	-1.7
France	2.9	2.0	-0.9	3.0	1.8	-1.2
Germany	2.6	0.9	-1.7	2.7	1.5	-1.2
Italy	2.4	1.9	-0.5	2.7	1.5	-1.2
United Kingdom	2.5	2.1	-0.4	2.7	2.1	-0.6
Japan	1.4	-0.5	-1.9	1.8	-0.4	-2.2
G-7	2.1	1.0	-1.1	3.0	1.1	-1.9

Source: Consensus Economics.

In addition to the significant impacts felt through its exports to the United States, Québec has also been directly affected by the short-term negative economic impacts arising from the terrorist attacks in the United States. Major layoffs in the sectors previously mentioned were announced soon after September 11. In addition, the heightened uncertainty prevailing since the attacks is reflected in a 15% decline in household confidence between June 15 and October 15, 2001, a similar drop to the one observed in the United States.

GRAPH 1.19

**MARKED DECLINE IN QUÉBEC CONSUMER CONFIDENCE
AFTER THE ATTACKS**
(index)



Source: Conference Board of Canada.

Key factors in renewed growth in 2002

The majority of experts anticipate an economic recovery beginning early next year, when the short-term negative impacts of the attacks and the bursting of the speculative bubble in the stock markets will be behind us. Several factors that are crucial to this recovery are already in place; others are being implemented through this Budget.

Major easing of monetary policy

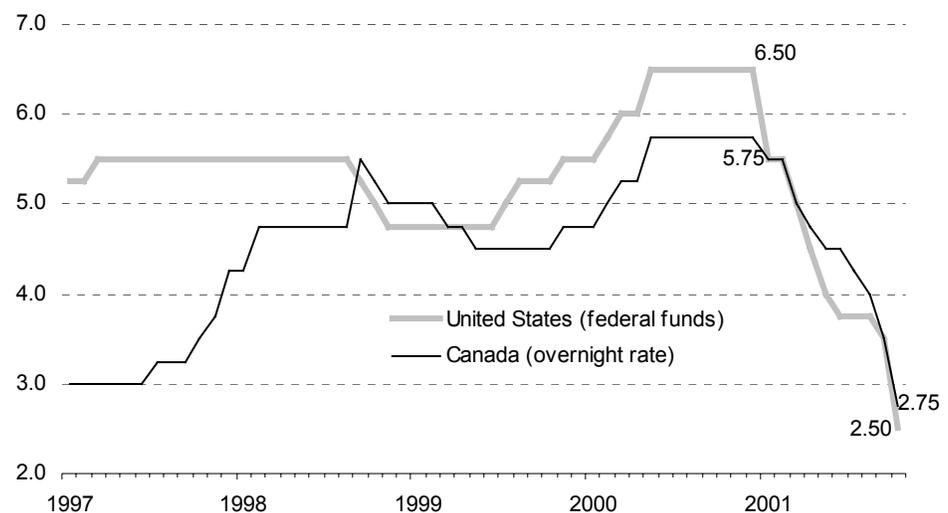
The American and Canadian central banks have already slashed their leading interest rates.

In the United States, the Federal Reserve cut the federal funds rate by 400 basis points during the first ten months of 2001, bringing the leading rate down from 6.5% in early January to 2.5% in October 2001, its lowest level since 1962. For its part, the Bank of Canada reduced its base rate by 300 basis points, to 2.75%. Since the attacks, the Federal Reserve has reduced its leading rates by 100 basis points, and the Bank of Canada, by 125 points. Given the weak growth prospects in the short term, further rate cuts may be made between now and the end of 2001.

GRAPH 1.20

MAJOR EASING OF MONETARY POLICY

(interest rate in percent)



Sources: DRI-WEFA and Bank of Canada.

Government economic support measures

Both the U.S. and Canadian governments have also implemented a major tax and budgetary stimulus in the past year. In Québec, the personal income tax reduction that took effect on July 1, 2001 will help sustain economic activity while increasing households' purchasing power by \$1 billion in 2001-2002 and \$3.5 billion by 2003-2004. In 2002, thanks to the cuts announced over the past two years, taxpayers will see an average 20% reduction in their annual income taxes.

As previously mentioned, the U.S. government has already put forth additional measures to stimulate its economy. The new measures announced in this Budget will further support economic recovery by increasing consumer purchasing power as well as the level of investment. These measures alone should boost economic growth by 0.7 percentage points in 2002 and help create or sustain some 30 000 jobs over three years, including 16 000 in 2002.

Revised outlook for 2001 and 2002

On the whole, Québec's economy should continue to grow, albeit at a more subdued rate than previously anticipated. Based on the economic support measures introduced through this Budget, 1.1% growth is expected in 2001 and 1.7% in 2002. These growth rates should translate into 30 000 new jobs this year and nearly 20 000 more next year. Given the foreseeable increase in the active population, the unemployment rate will rise slightly to an average of 8.9% in 2002.

More sustained economic growth and greater job creation are expected in 2003, with a more vigorous upswing in the U.S. economy and a rebound in high-technology investment in the United States.

TABLE 1.4

ECONOMIC GROWTH IN QUÉBEC: REVISIONS SINCE THE 2001-2002 BUDGET (real GDP, percentage change)

	2001	2002
2001-2002 Budget	2.7	2.6
Before September 11	1.7	2.3
After September 11	1.1	1.0
— Impact of measures contained in this Budget	---	+0.7
2002-2003 Budget	1.1	1.7

Upturn in exports in 2002

With the upturn in economic activity in the United States in early 2002, Québec should see a rapid recovery in its production of manufactured goods and in international exports. Office and telecommunications equipment should be among the first sectors to benefit from the increase in U.S. demand.

However, since the more marked slowdown in the U.S. economy and the problems experienced in the telecommunications sector resulted in a significant decline in this year's exports, the upturn anticipated in 2002 will not be sufficient to fully offset the downturn in 2001. Consequently, on the basis of annual averages, Québec's international exports, in constant dollars, should decline 7.4% in 2001 and 0.2% in 2002, before rebounding in 2003.

Continued growth in domestic demand

Sustained by fiscal and budgetary policies that are highly conducive to growth, as well as by low interest rates, domestic demand should continue to rise at a moderate rate both this year and next.

Thanks to personal income tax reductions and an improvement in the QST tax credits, the purchasing power of households will be maintained. This should bolster household confidence and enable an increase in real consumer spending of nearly 2% this year and next (3.9% and 3.3%, respectively, in current dollars).

Furthermore, given the current residential market conditions, i.e. low mortgage rates and low excess supply, housing starts should reach 26 700 units in 2001 and 27 700 units in 2002, higher levels than those recorded in recent years.

Following a slight downturn in 2001 owing to the completion of two major investment projects (Alcan and Magnola), private and public non-residential investment should revive with economic growth in 2002. Sustained by the investment acceleration program introduced in this Budget, non-residential investment by the public and private sectors should climb 5.7% next year.

TABLE 1.5

ECONOMIC OUTLOOK
(percentage change)

	2000	2001	2002	2003
OUTPUT				
— Real gross domestic product	4.7	1.1	1.7	1.9
— Gross domestic product	6.2	3.3	3.0	3.2
COMPONENTS OF EXPENDITURE				
— Consumption	4.8	3.9	3.3	2.9
— Housing starts ('000)	24.7	26.7	27.7	27.7
— Non-residential investment	6.1 ¹	-0.9 ¹	5.7	1.6
— International exports of goods ²	12.3	-7.4	-0.2	4.8
COMPONENTS OF INCOME AND PRICES				
— Wages and salaries	6.5	3.2	2.5	3.2
— Personal income	5.7	3.2	2.6	3.2
— Corporate profits	12.2	0.2	-0.5	5.7
— Consumer prices	2.4	2.8	2.1	1.6
LABOUR MARKET				
— Labour force	1.4	1.1	0.8	0.9
— Employment	2.4	0.9	0.6	1.2
— in thousands	80	30	19	40
— Unemployment rate (%)	8.4	8.6	8.9	8.6
INTEREST RATE – CANADA (%)				
— 3-month Treasury bills	5.5	3.9	3.0	4.4
— 10-year Canadian bonds	5.9	5.5	5.5	6.2

1 Statistics Canada, Private and public investment.

2 Constant 1997 dollars based on economic accounts.

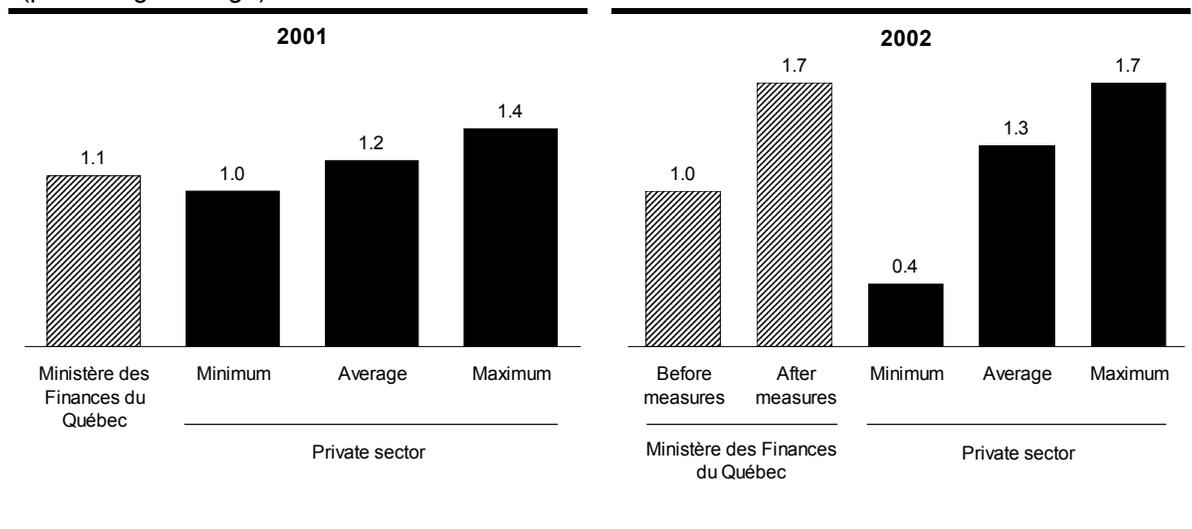
Comparison with private-sector forecasts

Private-sector forecasters anticipate 1.2% growth in the Québec economy in 2001, virtually the same rate as that used by the ministère des Finances du Québec (1.1%).

However, owing to the higher level of uncertainty than in previous years because of the September 11 attacks, they are divided on the rate of Québec's economic growth in 2002: the predicted growth ranges from 0.4% to 1.7%. On average, private-sector forecasters predict the economy will grow by 1.3%. The ministère des Finances du Québec anticipates slightly higher growth (1.7%), because it takes into account the impact of the economic support measures announced in this Budget.

GRAPH 1.21

ECONOMIC GROWTH IN QUÉBEC – COMPARISON WITH PRIVATE-SECTOR FORECASTS (percentage change)



Source: According to a ministère des Finances du Québec survey.