Observation

TD Economics
www.td.com/economics

August 22, 2011

CANADA'S ECONOMY – A FORTRESS OR A SAND CASTLE?

HIGHLIGHTS

- **The possibility of a double-dip recession in the United States has intensified in recent weeks – a risk that we peg at about two in five.**
- **On balance, Canada's domestic demand is more vulnerable to a U.S. recession or another nasty economic shock compared to the period leading up to the last downturn in 2008-09.**
- **While the business sector appears better positioned to weather a U.S. downturn, policymakers in Canada have less wiggle room on the fiscal and monetary fronts and households face larger debt burdens.**
- **In contrast to Canada's outperformance compared to its peers during the recent recession, a repeat performance would not be assured.**

Derek Burleton
Vice President and Deputy Chief Economist (Canada)
416-982-2514
derek.burleton@td.com

In recent weeks, there has been considerable focus on the growing possibility of another U.S. recession – a risk that we peg at about 40%. This prospect has raised questions about Canada's ability to withstand such a shock. Despite Canada's relatively strong economic fundamentals and the continued outlook for growth, the economy is more vulnerable to a nasty external surprise than it was prior to the recent recession in 2008-09. While the business sector appears better positioned to weather a U.S. downturn, policymakers in Canada have less wiggle room on the fiscal and monetary fronts and households face larger debt burdens. In contrast to the experience in the 2008-09 downturn – when Canada's economy suffered a considerably lesser blow than that Stateside – there is no assurance that a repeat would be in store in the event of a U.S. double dip. At a minimum, the Canadian economy would probably follow the U.S. into recession.

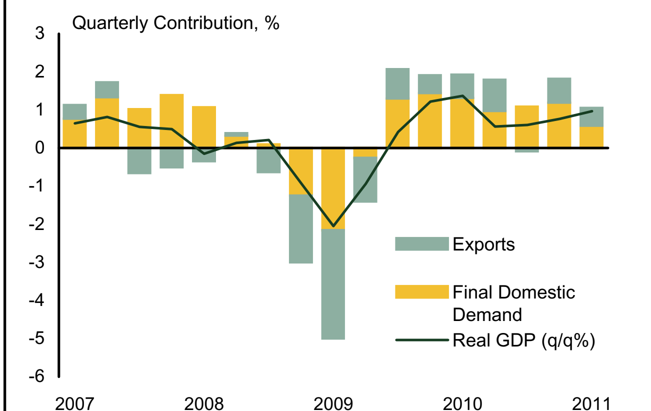
Less scope for policymaker response

In the table on the next page, we present key metrics corresponding to the situation today and that of the period leading up to the recent recession.

One of the bigger differentiating factors is the reduced flexibility of monetary and fiscal authorities in Canada to respond. In 2007, Canadian short-term interest rates stood at 4.25%, government fiscal balances were in surplus and combined government federal-provincial debt was sitting at 54%. Indeed, the subsequent and massive injection of massive monetary and fiscal stimulus helped to prevent a difficult externally-driven, export-led recession from being considerably worse. Canada's peak-to-trough decline in real GDP during the 2008-09 recession amounted to a sizeable 4%. But if the heavy losses in the export sector are stripped away, Canada's household and government sectors suffered a much tamer drop of around 2.5%. Canadian job losses during the downturn were also heavily concentrated in the export sector.

Today, a short-term interest rate at 1% leaves the Bank of Canada much less room to counter an economic shock without foraying into unconventional monetary policy options, such as quantitative easing. What's more, with some $166 billion dollars more in outstanding federal and provincial debt (62 percentage points as a share of GDP), governments would be harder pressed to go on another major spending spree.

CONTRIBUTION TO REAL GDP GROWTH



Source: Statistics Canada, Haver Analytics

TABLE 1- CANADIAN ECONOMIC INDICATORS - PRE AND POST 2008-09 CRISIS	2007 High	Current
Policy Response		
BoC Overnight Rate (%)	4.25	1.00
Government Deficit-to-GDP Ratio (%)		
Combined	1.4	-3.8
Federal	0.63	-2.2
Provincial	0.7	-1.6
Net Debt-to-GDP Ratio (%)		
Combined	54.1	61.5
Federal	29.9	34.1
Provincial	20.6	27.4
Household Sector		
Unemployment Rate (%)	6.0	7.5
Debt-to-PDI (%)	133.0	147.0
Debt Service Ratio (%)	8.3	7.6
Home Price-to-Income Ratio	4.8	5.2
Business Sector		
Oil prices (WTI, U.S. $ per Barrel)	90.9	87.0
Canadian Dollar (Cad per USD)	1.02	1.03
Profit Margin (%)	8.72	8.02
Debt-to-Asset Ratio	1.01	0.99
Quick Ratio (Liquid assets-to-debt)	0.12	0.12
Debt-to-Equity Ratio (%)	149.0	143.0
Price-to-Earnings Ratio	18.4	20.0
Terms of Trade	1.22	1.25

Source: Statistics Canada, Bureau of Economic Analysis, Haver Analytics

Household vulnerabilities have risen

The household sector's flexibility to respond in the event of a severe bout of external headwinds is even more constrained. For one, the jobless rate remains more than a full percentage point above its pre-recession trough. Household debt as a share of after-tax income is considerably higher. It may be the case that the burden of debt service costs is actually lower today than four years ago due to the benefit of lower borrowing rates. However, that could quickly change if income flows are abruptly cut off as a result of, say, a surge in layoffs. The higher home price-to-income ratio also suggests a larger degree of froth in the nation's housing market despite the gyrations in home prices since 2007. By our measure, home prices are currently 10-15% over-valued. The bottom line is that household debt leaves households with less financial maneuvering room.

Business balance sheets stronger

Similar to the 2008-09 experience, a U.S. recession would swiftly hit Canada's economy through the export channel. As such, many businesses would be in the line of fire. Roughly 70% of Canadian exports remain U.S.-bound while roughly one-fifth of business funding is generated in U.S. markets – shares which have not changed materially since 2007. At the same time, however, Canadian businesses would be in a better position to deal with the storm this time around. Businesses, on average, are holding less debt and are have more liquid assets. With commodity prices and the Canadian dollar in the same ball-park today as in 2007, profit margins are on the same magnitude.

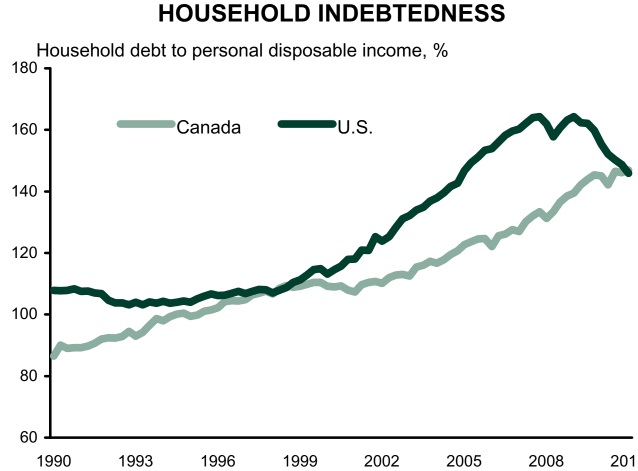
Another important factor to consider – especially when the level of risk to the Canadian business sector is considered – is the vulnerability of the U.S. economy compared to 2007. While the U.S. still faces a mountain of structural challenges – least of which is its ballooning government debt-load – it is highly unlikely that the economy is poised to suffer a contraction along the same line as that in 2008-09. Unlike Canada, households and housing markets have already undergone massive adjustments. Housing starts in particular can't go much lower. Business balance sheets are also in decent condition notwithstanding the sluggish recovery to date.

Bottom Line

Canada's economy headed into this summer's turmoil in relatively good shape and our base case remains one of modest growth. Still we can't ignore the simple fact that households and governments – two sectors that make up about four-fifths of Canadian economic activity – have a reduced capacity to respond to unanticipated negative events than was the case four years ago.

The prevailing view is that if the U.S. economy were to fall into recession, Canada's economy would likely follow suit. But by virtue of its fundamental strengths, many believe that the downturn would be less severe and the economy would recover more quickly than would be the case south of the border. Given Canada's increased domestic vulnerability, such an outcome would not be guaranteed.

HOUSEHOLD INDEBTEDNESS



Source: Statistics Canada, Federal Reserve Board, Haver Analytics