TD Bank Financial Group

TD Economics

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CANADA AND THE U.S.: THE ODD DECOUPLE

- **The Canadian and U.S. economies can and do occasionally decouple.**
- **Potential wedges include resource sector and manufacturing sector orientation, fiscal stances, the regulatory environment, and diminishing trade ties.**
- **But powerful adhesives counteract many of these drivers in the form of a floating exchange rate and independent monetary policy.**
- **Our present outlook suggests an aggregate economic performance more similar than different, even if the underlying drivers are likely to vary.**
- **A sharp downturn in the U.S. – were it to occur – might create a more profound decoupling scenario.**

Overview

Canada remains both a close neighbour and an intimate trading partner to the U.S. Conventional wisdom suggests that as the U.S. economy goes, so goes Canada. There is a great deal of truth in this belief, due both to the trade ties and a broadly similar economic structure. But at the same time, there can most certainly be the odd decoupling of the two nations. Indeed, the link may be declining, and special factors can occasionally drive a wedge between the two.

Although the economic outlook for the two countries is not hugely different for the immediate future – modest to moderate growth for each – the underlying drivers differ substantially. And we should not assume that a profound U.S. slowdown – were it to occur – would necessarily translate into a substantial drag on Canada.

We are not alone in making this observation: Senior Deputy Governor Paul Jenkins of the Bank of Canada recently noted that Canada-U.S. trade ties are diminishing, and that "we have seen a number of economic shocks that have affected the U.S. and Canadian economies differently."

Canada's capacity to at least partially decouple from the U.S. is related to several factors, all of which we discuss in this report. We look at the historical link between the two economies and find that it is relatively strong, but not ironclad. We observe several structural differences between the two nations that create the potential for occasional decoupling. We note numerous factors that have contributed to greater economic health in Canada lately, including fiscal stimulus and a favourable environment for the resources industry. And we observe that Canada's trade ties to the U.S. have been weakening. Finally, we contemplate two mechanisms that help to minimize the divergences between the two economies: independent monetary policy and a floating exchange rate. This last subject – a floating exchange rate – does indeed normally smooth the operations of the two economies. But in the present instance, it is arguably doing more than that, exerting an outright drag on Canada due to currency strength that exceeds the fundamentals.

Top-Down Perspective

Allow us to start from a top-down perspective, evaluating how similar Canada-U.S. GDP, domestic demand, employment, bond yields, inflation, and the exchange rate have been in recent years.

GDP

From a top-down perspective there is most certainly a close historical relationship between Canadian and U.S. real GDP. The correlation of year-over-year growth between the two is a remarkably strong +0.75. There are, of course, instances when one was growing substantially more quickly than the other, but the directional trend is usually the same.

Domestic Demand

This close historical link is not simply due to bilateral trade ties. The broadly similar economic makeup of the two countries has supported a similar trend even when one looks solely at domestic demand. The link is of course weaker without trade ties included, but the correlation in annual growth between the two is still a solid 0.46.

Employment

The potential for divergence between Canada and the U.S. becomes more apparent when one examines job growth in both countries. Although the correlation between the two is a solid 0.50, there are very clear (if occasional) divergences. Most notably, there was a sharp divergence in job growth in 2002-2003, with as much as a 4 percentage point gap in Canada's favour between the Y/Y employment growth rates in the two countries. Similarly, the job growth rate has again diverged recently, with Canadian employment now rising 1.3% more quickly on an annual basis than the U.S.

Given that the tightness of the labour market is arguably a more direct measure of inflationary pressures than GDP growth itself due to the fickleness of productivity, these instances of divergence between the two labour markets speak to a potential for occasionally divergent monetary policy.

Bonds

We should also note that Canadian and U.S. bond yields can diverge substantially on occasion. Over the past nine months, Canadian 2 year bond yields have risen by 130bp relative to the U.S. 2 year bond yield. This is a substantial difference. Over the past decade, the Canada-U.S. 2 year spread has ranged from as much as 200bp below the U.S. to 225bp above. This represents a substantial decoupling of a sort.

Taking an even broader perspective, it is notable that Canadian bond yields were consistently and substantially higher than U.S. bond yields throughout the latter half of the 1980s and first half of the 1990s. Although that era now appears to be over due to a much more manageable debt-GDP ratio and more credible monetary policy, it illustrates the potential for occasional sustained divergence between Canadian and U.S. interest rates.

In short, Canadian and U.S. yields still tend to move in a similar direction to each other, but they are hardly tied at the hip.

Inflation

Canadian and U.S. inflation have experienced a similar general trend over the years, mutually driven as they have been by the ebb and flow of global commodity prices or impact of the latest global economic cycle. But inflation has occasionally diverged between the two countries, too, driven by a combination of currency differentials and structural economic differences. These differentials do not merely flit into and out of existence on a monthly basis: Canadian inflation was historically higher than in the U.S. through much of the 1980s and the early 1990s, whereas Canadian inflation has tended to be lower than in the U.S. since 1992.

Currency

The Canada-U.S. exchange rate has certainly varied over the years, suggesting that underlying conditions in the two countries are not always identical. The Canadian dollar – currently worth $1.02 U.S. (0.98 USDCAD) – has been as strong as $1.10 U.S. (0.90 USDCAD) and as weak as $0.62 U.S. (1.61 USDCAD). Occasionally, the currency has moved on little more than a whim, but usually the exchange rate is motivated by factors that drive a wedge between the Canadian and U.S. economies, like commodity prices, relative central bank rates, current account and fiscal surpluses, and so on. The very fact that the currency varies with regularity is proof positive that the two economies are not perfectly coupled.

Bottom-Up Perspective

Having established that Canada and the U.S. have historically been fairly closely tied in their rate of economic growth, though with occasionally larger differences in variables like employment, the bond market, inflation, and the currency – we now turn to the underlying compositional differences between the two countries.

Goods versus Services

Canada is a more goods-oriented country than the U.S. – almost 24% of Canadian workers are in a goods-producing sector, while this figure is just 16% in the U.S. Thus, Canada has a 50% higher orientation towards goods than the U.S. The trend in goods-based employment in both countries has been declining on a roughly parallel track. The corollary to these observations is that the service sector has a weightier role in the U.S., and this orientation has been rising in both countries. This goods orientation has been both a blessing and a curse for Canada. The underlying natural resource orientation has put Canada on an elevated footing relative to the U.S.; the underlying manufacturing orientation has hardly been beneficial.

Manufacturing

Canada remains a little more oriented towards manufacturing than the U.S., with a 12% employment share versus 10%. The employment share for this sector is on the decline in both countries, though the decline is now somewhat steeper in Canada as a sort of "catch-up" occurred after Canadian manufacturers were able to defer the inevitable job seepage towards developing nations while the Canadian dollar was unnaturally weak in the 1990s. Manufacturing woes experienced broadly among developed nations have extracted a greater toll on Canada recently due to this seepage, to currency strength, to waning U.S. demand, plus to the high cost of commodity prices.

Natural Resources

Canada is profoundly more oriented towards natural resource-related sectors than the U.S. The U.S. share of employment in "Natural Resources & Mining" is just 0.5%, while the Canadian share of employment in "Forestry, Fishing, Mining, Oil & Gas" is a much more substantial 1.9% – almost four times the size, with a general upward trend over the past five years (though slightly unwound recently). The commodity boom has thus been much more favourable to Canada than the U.S. A commodity bust would be more detrimental.

Consumption

The U.S. is a much more consumer-driven economy than Canada. U.S. consumption represents a remarkable 71% of GDP, a proportion that has been rising steadily since the mid-1990s (marred only by a slight retrenchment this year). By contrast, Canadian consumption represents just 60% of GDP, a fraction that has increased substantially over the past few years, but has not grown as much as the U.S. since the mid-1990s. This suggests that consumer conditions have a much more profound impact on the U.S. than on Canada. To the extent that the consumer outlook is not especially bright (particularly in the U.S.), this suggests a downside risk to the U.S. that is not shared equally by Canada.

Demographics

Canada's population is aging more quickly than in the U.S. This has few implications in the near term, but could have a growing importance over the next several decades, as Canada's population growth slows and the employment rate falls more sharply than in the U.S. This could speak to an eventual slower pace of economic growth in Canada, though we emphasize that it is not a factor playing a major role today.

Regulations

The regulatory environment in Canada is different than the U.S. in certain ways. In turn, this can and does result in occasionally massive consequences, not all of which are intended. It is impossible to factor in every regulatory nuance in the two countries, but an extremely timely example may do justice to the subject.

The poster child for the regulatory differences is the remarkable contrast between the Canadian and U.S. housing markets in their present incarnations. The U.S. housing market is extremely weak, and continues to decline. By contrast, the Canadian housing market has held together quite nicely, and shows no obvious sign (or need) of crumbling. In turn, this means that Canadian consumers are much more enviably positioned than U.S. consumers. That represents the most profound difference between the Canadian and U.S. economies right now, and is the factor that most supports a decoupling of the two economies going forward.

It is possible to trace the relative health of the Canadian housing market at least partly back to regulatory matters. The Canadian banking sector was less adventurous than the U.S. over the past several years, choosing not to mimic the U.S. innovations of ever-more precarious mortgage products that are now coming home to roost in the form of elevated default rates, major bank losses, and declining home prices. Canada's securitized mortgage market is also substantially smaller than in the U.S, leaving more debt on the balance sheet, and thus ensuring caution. These differences can be attributed at least in part to a less competitive mortgage market in Canada – one where a handful of big banks dominate. In turn, this is at least partly due to government regulations that limit foreign competition in the sector. The other regulatory influence upon this sector has been the fact that even risky mortgages in Canada are insured, whereas in the U.S. this is not the case. These two factors now position the Canadian economy to perform somewhat better than the U.S. on housing and consumer related factors.

Culture

Cultural differences may also play a role when comparing Canada to the U.S. Canadians tend to be more risk averse than Americans. For instance, Canadians are generally more inclined to invest in safe investments, and less inclined to be innovative (as reflected in a lower rate of patents per capita).

This natural conservatism would seem to suggest that the Canadian economy might grow less quickly during boom times, and more quickly during periods of economic weakness. It is difficult to establish this empirically, unfortunately, and the effect is probably dampened (if not completely countered) by Canada's orientation toward the relatively volatile commodity sector.

Nonetheless, the implication that extends from this Canada-U.S. cultural difference (however slight it may be) is that Canadians were less inclined than Americans to speculate in the housing market on further home price gains, and less likely to pursue mortgages that were onerous in a rising interest rate environment. The Canadian mortgage delinquency rate remains extremely low, for instance. Along with the aforementioned regulatory differences, these two factors – differing regulations and culture – have ultimately translated into a substantial economic divergence between the two countries recently.

Fiscal Affairs

Fiscal stimulus can vary widely between the two economies. The U.S. economy soared in 2003 on substantial tax cuts that were not replicated in Canada. By contrast, recent fiscal stimulus could ignite the afterburners in Canada while relative fiscal restraint in the U.S. acts as a drag there.

One-Time Shocks

There are also a variety of one-time shocks that can hit a country, sending it careening off of its previous trajectory. To the extent that these shocks tend to hit a single country at a time, they present an opportunity for occasional decoupling between Canada and the U.S.

These one-time shocks can come in a number of forms. The year 2003 was a memorable one in Canada as the economy was buffeted by SARS and mad-cow disease scares – events that seriously dampened Canadian economic activity without having a similar effect on the U.S. By contrast, the U.S. confronted the economically damaging 9/11 terrorist attacks in 2001, whereas Canada was less directly affected. In 2005, the U.S. was hit by Hurricane Katrina – another shock that spared Canada. And one might even include military conflicts into this category. The U.S. operation in Iraq – with its economic consequences good and bad – has no parallel in Canada.

Other Miscellaneous Factors

Our brief analysis hardly does justice to the variety of structural differences between Canada and the U.S. Canada's climate is less varied and generally colder than the U.S. The home ownership rate is lower in Canada than the U.S. The list goes on. All of these have the potential to decouple the economies at different points in time.

Weakening Trade Ties

Canada-U.S. trade ties are extremely strong, and yet clearly diminishing steadily. Canada used to export as much as 87% of its exports to the U.S. – this figure has now declined to 75% over the span of just a few years. Combined with a generally declining proclivity to export in general, the U.S. share of Canadian output has dramatically declined from roughly 40% in 2000 to just 27% today. This represents a decline in the Canada-U.S. link of about a third over just seven years.

The decline in orientation toward the U.S. has been matched by increasing demand from non-U.S. trade partners. These non-U.S. exports have more than doubled since 2003.

By our estimation, Canadian exports are roughly 55% raw materials. Should the U.S. falter in the future, it stands to reason that Canadian exporters may be able to capitalize on strong global economic growth, rising commodity prices, and an insatiable appetite for commodities, and be buffered from the worst of any possible U.S. correction.

Autos represent roughly 16% of Canadian merchandise exports. The outlook for this sector may arguably be somewhat diminished now that U.S. consumers are looking strained, U.S. autoworkers have accepted health care concessions, and the Canadian dollar is so strong. But any decline in Canadian auto exports will be almost invariably overstated as Canada imports a huge number of partially completed autos from the U.S. as well, and so when auto exports drop sharply, auto imports often do the same (and vice-versa). The actual economic impact of the auto sector is much less than its export composition would suggest (3% of the economy versus 16% of exports).

In the interest of a balanced assessment, it is also worth noting that Canadian exporters are arguably more exposed to the U.S. housing slowdown than one might initially assume due to Canada's large forestry sector.

On the whole, the trade ties nonetheless do appear to be softening between the two countries, creating scope for an occasional bout of decoupling.

Buffers

Despite all of the differences between the two economies, there are two important buffers that can prevent the two economies from getting too out of synch (and that indeed keep all of the world's economies from diverging too profoundly).

Currency

The floating Canada-U.S. exchange rate presents one factor that can materially benefit one country at the expense of the other. Indeed, it often serves as a buffer, propping up the weaker economy while adding friction to the stronger economy.

In the present environment, soaring commodity prices provide a handsome boost to the commodity-oriented Canadian economy. But this boost is tempered by the Canadian dollar, which has proportionally strengthened, creating its own drag on the Canadian economy and a downward influence on inflation. In exactly the opposite manner, high commodity prices are damaging to the U.S. economy, but this is tempered by the softening response of the U.S. dollar.

Via this mechanism, many of the structural differences between the two countries cited in the previous section are frequently offset, at least temporarily. In turn, this observation helps to square the otherwise peculiar differences between the top-down perspective we have presented (which suggests relatively closely correlated economies) and the bottom-up analysis (which suggests that there should be differences): a floating currency has helped to smooth over many of the structural differences.

Monetary Policy

By its very definition, monetary policy helps to smooth the differences between the two economies. Excessively strong economic growth is tempered with a tighter monetary policy; economic weakness is boosted by looser monetary policy. This is not with the explicit intention of bringing the Canadian and U.S. economies closer together, but it has that implicit effect.

Whether this presents an argument in favour of a "coupled" set of countries depends upon one's perspective. If the ultimate question is whether GDP is more coupled due to this factor, then the answer is "yes". But if one's ultimate definition of coupling or decoupling is whether monetary policy travels in a similar direction in the two countries, then clearly one risks degenerating into a circular argument.

Turning objectively to the historical record on that last subject, Canadian and U.S. monetary policy do tend to go in similar directions. Both countries cut rates substantially in 2001; both hiked rates gradually between 2004 and 2006. But there are also many cases of divergence between the two. Over the past decade, Canada's overnight rate has been as much as 250bp below the U.S. fed funds rate, and as much as 225bp above it. Clearly, this suggests the potential for divergences in monetary policy. On occasion, the direction of rate changes has even been opposite – the Bank of Canada hiked while the Fed cut in 2002-03, and the Bank of Canada hiked by 25bp in July of this year (though this could be unwound shortly), just before the Fed cut by 75bp. Clearly, then, one should not assume that monetary policy in the two countries will be tied at the hip, as much as they do often trend in the same direction.

The Immediate Outlook

We have established that Canada and the U.S. usually go in a similar direction, but that a myriad of opportunities exist for occasional decoupling.

In the present instance, the most likely outcome is one in which the two economies grow at a broadly similar rate

– moderately below potential, but hardly recessionary. Despite this superficial similarity, the engines of growth may differ greatly between the two. In Canada, fiscal stimulus, healthy domestic demand, a solid housing sector, and a robust raw materials sector are likely to support growth, but exports should lag due to manufacturing weakness, unorthodox Canadian dollar strength, and softer U.S. demand. In the U.S., consumption should soften, and housing activity should remain weak, but exports are likely to be spurred forward by recent Fed rate cuts and the U.S. dollar's depreciation.

Should the U.S. weaken more than we forecast – to the point of flirting with recession – there is reason to think that there could be scope for a partial decoupling, even though Canada would clearly be slowed as well. Canada is less linked to the U.S. than in the past, and so would not be dragged down as much as the historical norm. The recent interplay of regulatory and cultural factors would likely keep the Canadian housing market on solid footing while the U.S. housing market continued to stumble. In turn, Canadian consumers would be better situated. And if commodity prices continued to boom, this would make the case for strength in the resources sector – offset partially by a presumable depreciation in the U.S. dollar and a proportionate appreciation in the Canadian dollar. The events of 2001 – when the U.S. economy turned to recession while Canada bucked the trend – provide an apt example of a classic partial decoupling.

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