TD Bank Financial Group

TD Economics

Special Report

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SASKATCHEWAN'S ECONOMIC AND FISCAL OUTLOOK

Risk of a return to budget deficits amid slumping commodity prices

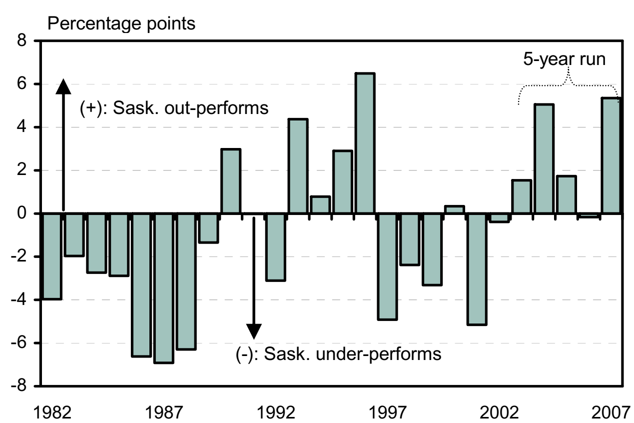
HIGHLIGHTS

- **Downdraft in commodity prices has knocked Saskatchewan off its high growth path**
- **Saskatchewan's nation-leading 0.6% growth in 2009 will mask a near 5% drop in nominal income**
- **Government surplus to be wiped out in FY 2009-10, with possibility of a deficit in FY 2010-11 unless spending increases can be contained**

Just under a year ago, TD Economics released a comprehensive study on the Saskatchewan economy entitled: "Saskatchewan Economy of 2008: The Resurgence of the Resourceful". That study argued that while commodity prices would always be prone to major gyrations, the longer-term outlook for the economy had never looked brighter in view of the province's diverse mix of resource industries and the positive fundamental changes put in place over the past several years.

We stand by that longer-term view. But the province's near-term economic and fiscal performance is clearly facing far greater challenges than we had anticipated in the 2008 study. The U.S. economy is in a virtual free fall, financial markets remain under stress and the world economy faces its most synchronous and severe global recession in the post-War period. Next year will likely mark an improvement in global fortunes, but far from a return to the boom-times of recent years. For a small, open and resource-based economy such as Saskatchewan, such a negative turn in fortunes will prove to be a major economic setback with significant spillover implications for the province's fiscal position.

REAL GDP GROWTH - SASKATCHEWAN COMPARED TO THE REST OF CANADA*



* Canada excl. Saskatchewan. Source: Statistics Canada.

Saskatchewan's outperformance widened in 2008

Lining up most economic indicators available at the provincial level, an outright winner emerged in the last couple of years: Saskatchewan. Indeed, while Alberta had been running the show prior to that and grabbed the most attention with its booming energy sector, larger size population and economy, Saskatchewan nonetheless came in first place in terms of real economic growth in 2007, which brought its outperformance vis-à-vis the rest of Canada to a sizeable 2.7 percentage points per year in the 2003-07 period. In 2007 alone, nominal GDP growth – which is a proxy for gains in the combined current-dollar income of households, governments and businesses – came in at a whopping 11% in Saskatchewan, nearly double the 5.7%

rate of growth of the rest of the country.

While a complete set of figures is not available for 2008, we estimate an even larger out-performance. While the Canadian economy as a whole is estimated to have expanded by 4.7% nominally last year, Saskatchewan is likely to see another double-digit growth performance – our latest estimate for 2008 nominal GDP growth is about 14%. Estimates for 2008 range widely – for example, in its November mid-year report, the Saskatchewan government projected nominal GDP growth at a massive 32.3%, which does not fully reflect the sharp drop in commodities prices in our view. What is clear, however, is that the province enjoyed another banner year in 2008.

In real terms, the wedge between Canadian economic growth and that of the province is expected to be large as well, with the Saskatchewan economy growing over 5 times more – at 3.2% according to our estimates – than the anemic 0.6% growth rate we expect at the national level. Saskatchewan Finance's last published estimate for 2008 growth is an even healthier 4.4%.

What lies ahead?

Saskatchewan's economy headed into 2009 armed with more momentum than other provincial economies, which will help to support its real GDP showing for the year as a whole. TD Economics' forecasts that Saskatchewan will be the only Canadian province to turn in a positive reading this year, albeit a scant one of just 0.6%. But just as the bigger story has been the commodity-induced explosion in nominal incomes over the past several years, the unwinding of some of the gains will be the dominant development in 2009. More specifically, the abrupt reversal in prices for most of the province's key commodities since the summer of last year will pull down nominal GDP by a sizeable 4.7% this year, which would rank as the second-largest drop behind Alberta's near double-digit (-9.7%) pullback.

In Canadian dollar terms, our overall TD Commodity Price Index (TDCI) is forecast to be 50% lower on an annual average basis. On the plus side, this drop would have been worse were it not for a likely depreciation in the value of the Canadian dollar against the greenback, which cushions the blow from the deterioration in commodities prices quoted in U.S. dollars. TD Economics expects the loonie to fall by 12% on average in 2009.

The decline is expected to be broadly based across the commodity space. In domestic currency terms, the energy price sub-index, consisting mostly of crude oil and natural gas, will lead the decline with a 57% drop. Our agricultural price index, which includes the major crops (wheat, canola, and barley) produced in the province will likely see a lesser 27% drop this year. On the flip side, potash prices are expected to strengthen by a significant 56% compared to last year's average reflecting the impact of producer supply cuts and recent favourable contract prices with Japan and South Korea. Specific price forecasts for the province's key commodities are provided in the accompanying table.

(Per cent, unless otherwise noted)			
Calendar Year	**2008***	**2009f**	**2010f**
Real GDP growth	3.2	0.6	1.4
Nominal GDP growth	14.2	-4.7	3.5
CPI inflation	3.2	1.0	1.7
Employment growth (000s)	10.9	3.1	-1.0
Unemployment rate	4.1	5.2	6.1
Retail sales	11.3	1.5	4.0

* Actual when available.
F: Forecast by TD Economics, Feb. 2009.

COMMODITY PRICE FORECAST

Calendar Year	2008	2009F	2010F
Oil (US$/barrel)	99.58	36.25	58.00
Natural Gas (US$/MMBtu)	8.86	4.86	6.44
Potash (US$/tonne)	510.80	700.00	700.00
Wheat (US$/mt)	450.96	332.50	380.00
Barley (US$/mt)	202.94	132.50	151.50
Canola (US$/mt)	533.24	356.25	372.50
US$/C$	0.94	0.83	0.88
Oil (C$/barrel)	105.57	43.67	65.91
Natural Gas (C$/MMBtu)	9.39	5.86	7.32
Potash (C$/tonne)	541.50	843.37	795.45
Wheat (C$/mt)	478.07	400.60	431.82
Barley (C$/mt)	215.14	159.64	172.16
Canola (C$/mt)	565.29	429.22	423.30

F: Forecast by TD Economics, Feb. 2009

First in line to suffer the blows of this highly synchronized global recession are the external indicators like international exports and manufacturing shipments. The value of manufacturing shipments dropped by a whopping 14.2% in December, marking the worst drop for that month on record. Unfortunately, the data are much more likely to continue showing declines before they improve any time soon.

Further, the domestic economy is clearly not immune to these global headwinds. The pace of growth in wholesale and retail sales has been easing considerably. Year-over-year growth in retail sales revenues has slumped from 11-

12% in September-October, as well as mostly double-digit growth in the 18 months prior, down to only 2.7% in November. Wholesale trade has also come off the boil, recording year-over-year growth of 35% in November compared to 50-70% as of late last summer. Upcoming figures for months following November for both these indicators will likely confirm these downward trends.

Meanwhile, residential construction, as measured by residential building permits and consequent housing starts, is in retreat after peaking last summer, like most everywhere else across the country. By our forecasts, there will be nearly 30% fewer housing starts in the province this year compared to last year, with some residual risk pointing to even fewer starts. Looking at recent data from the existing home market paints a similar picture. Existing home sales were down 35.1% in January. While existing home prices, with an average year-over-year increase of 11.0% in January, stand in stark contrast to trends for most others areas of the country, this is largely because Saskatchewan came late to the housing party. It is only a matter of time – and likely much sooner than many expect – before home prices in Regina and Saskatoon flatten out and retreat after the 30%+ annual appreciations of 2007-08.

A rising unemployment rate combined with an understandably fragile consumer psyche will continue to weigh on sales of new and existing homes in the foreseeable future. Past erosion in home affordability, combined with the ongoing rebalancing in the supply-demand balance in favour of potential buyers, will eventually be reflected in a significant softening in home price trends. We expect the average home price for the province to slide by 12-15% from its projected peak this spring through until the end of 2010. Certainly, the fact that homes are still appreciating is positive from a home equity standpoint in the current environment. Most homeowner households in other parts of the country are being faced with the double whammy of stock market pullbacks along with depreciated homes, which is particularly difficult for those nearing retirement. We caution, however, that just because the province has not seen home prices decline yet should not be taken to imply they will not. Coming late to this downturn, it is more likely in fact that while Canadian home prices stabilize sometime in 2010, the province might have to wait until 2011 for such stability to take hold.

Rebounds in economic activity outside of housing are to be expected in 2010 across the board, as the U.S. and world economy creep out of this recession. This will help commodity demand and prices gain some traction. Our overall TDCI in Canadian dollar terms is expected to increase by 24% in 2010, lead by a 36% increase in the energy price component. The agricultural prices sub-index should see a much more modest 6% gain. Potash prices, meanwhile, are expected to be essentially flat in 2010. Underneath our Canadian dollar value forecasts for these commodity prices is an expected 6% appreciation in the domestic currency against the U.S. dollar.

The obvious and non-negligible wild card in the entire outlook is how long and how deep the U.S. recession will turn out to be. While there is already a wide range of opinions to be had as to whether, in 2010, the U.S. economy will come out of the gates with some vigour or simply crawl out of its hole like a snail, we are being cautious given many of the downside risks that remain, notably consumer indebtedness.

SASKATCHEWAN GOVERNMENT'S FISCAL POSITION
(Millions of dollars, unless otherwise noted)

	Est.*	Proj.*	Proj.*
Fiscal Year	08-09	09-10	10-11
REVENUES	**11,700**	**10,150**	**10,550**
% change	24.5	-13.2	3.9
Resource Rev.	4,000	2,750	3,000
Other Revenues	7,700	7,400	7,550
EXPENDITURES	**9,700**	**10,140**	**10,650**
% change	11.5	4.5	5.0
Discretionary Exp.	9,190	9,650	10,145
Debt-Service Costs	510	490	505
Underlying balance	**2,000**	**10**	**-100**
Net transfer from/to(-) GFSF	0	0	100
Surplus/Deficit (-)	**2,000**	**10**	**0**
% of GDP	3.8	0.0	0.0
GFSF Balance	1,100	1,100	1,000
Gross Gov't. Debt	**4,262**	**4,262**	**4,262**
% of GDP	8.2	8.2	8.2

* Estimate and projection using TD Economics forecasts as at Feb. 2008

Risk of deficit returning beyond 09-10

The accompanying table provides TD Economics' "status-quo" fiscal projections for the next two fiscal years. Revenues are set based on our views on the province's nominal income performance and expected commodity prices. The spending profile is predicated on the assumption of running health-care spending at its recent trend rate of about 6% per year. Other discretionary spending areas are held at population growth plus inflation. All combined, program spending is held at 5% per year, which is significantly lower than the 7.6% rate recorded over the past three fiscal years. Debt-service costs are based on TD Economics' expectations on interest rates.

The big shocker comes on the revenue side in fiscal 2009-10. While personal income tax revenues should hold up better than resource royalties and corporate income tax receipts, the overall tally is likely to come up short vis-à-vis prior expectations of continued growth. For fiscal year 2009-10, we expect combined revenues to shrink by 13%, led by a 31% decline in non-renewable resource revenues. In fiscal year 2010-11, a moderate recovery in commodity prices and in overall economic activity will pull revenues higher, but the overall take is expected to remain well below last fiscal year's peak of nearly $12 billion.

Based on this revenue profile – and our "status-quo" spending assumptions – the province is not only on track to see its large $2 billion estimated surplus for fiscal 2008-09 wiped out in fiscal 2009-10, but faces the return of a modest deficit (before transfer from the Growth and Financial Stability Fund (GFSF)) in fiscal 2010-11.

While the risk to Saskatchewan's finances – and notably the return to sizeable deficits – remains lower than in many other jurisdictions in Canada, the increasing fiscal squeeze caused by falling revenues represents a major near-term challenge for the provincial government. The government is facing additional pressures that we have not built into our status-quo projections, most of which stem for the past provincial election campaign. These include a pledge to lower education property taxes and to implement municipal revenue sharing. What's more, there are a number of public sector union contracts up for renegotiation in the year ahead, which could potentially add millions to the tab. The extent to which the provincial government moves on these fronts would raise the risk of a return to more significant deficits in Saskatchewan.

The bottom line

Since TD Economics' comprehensive economic study on Saskatchewan in 2008, the province's near-term outlook has been sideswiped by the worst global recession in the post-war period. And while the province's fiscal position remains considerably more favourable than most in Canada and around the world, a tightening fiscal noose will make planning this year's budget more challenging than at any time in the past half decade.

Derek Burleton
AVP & Director of Economic Analysis
416-982-2514

Pascal Gauthier, Economist
416-944-5730