CANADA'S ECONOMIC FORTUNES DEPEND HEAVILY ON PROSPECTS FOR CHINA

TD Economics investigates what a downturn in China would mean for Canada

Toronto, March 14 2011 – A new TD study finds that a 'hard-landing' in China's economy would be a major blow to the Canadian economy. The direct impact on trade would be limited because of Canada's limited exports to China. However, a major deceleration of economic growth in China would lead to a global recession and would cause a sharp correction in commodity prices, which would dramatically weaken the Canadian economy.

"Canada would be very vulnerable to any unanticipated economic weakness in China," said Craig Alexander, Chief Economist for TD Bank Group, who co-authored the report with Pascal Gauthier, Senior Economist.

The explosive growth of China's economy has been one of the dominant economic and financial themes over the last decade. In the past year, however, China has been imposing policies to keep real estate prices and consumer inflation – currently around 5 percent – in check. With recent spikes in the price of energy and agricultural commodities, inflationary pressures for sizeable portions of the consumption basket are unlikely to abate in the near-term. Legitimate concerns exist over China's ability to rein in growth and stifle inflationary pressures without triggering a harder landing that could derail a fragile global recovery. While TD Economics believes that the most likely scenario is for China's economic growth to moderate to 9.0-9.5 percent in 2011 to 2013, there is always a risk when policy is being tightened that it could lead to an unexpected softening of economic conditions.

The TD report explores the possible consequences of a more severe slowdown in China, where China's real GDP growth drops to 5 percent in 2012 before edging up to 7 percent in 2013. "This is for illustrative purposes only and does not reflect our base case expectations, but it is important to understand how such an outcome could impact Canada," said Alexander.

Under such a scenario, world GDP growth would likely be cut in half to a pace of close to 2%, which is historically consistent with a global recession. For Canada, the direct trade impact would be relatively small, shaving perhaps half a percentage point from Canadian economic growth. However, Canada's indirect exposure is much more significant. A recession in China would slam commodity prices and investment, as well as erode Canada's terms of trade and external balance. The study estimates that a Canadian trade-weighted index of commodity prices might plunge 30 percent to 40 percent. An offset to the negative commodity shock would come from a much weaker Canadian dollar that would be supportive to U.S.-bound exports, but the offset would only be partial during a global downturn.

From a base case of 2.5 percent growth, Canadian real GDP growth would weaken to 1.0-1.5 percent in 2012. In nominal GDP terms, national income growth would be deprived of about 6 percentage points – an income loss of roughly $100 billion. The impact on the Canadian economy would also not be even across all regions. The commodity correction would lead to more concentrated weakness in Western Canada and oil-rich Newfoundland & Labrador.

"If anything, our estimations could prove conservative, as the full impact on global financial markets is difficult to assess. The world has never been so dependent upon the Chinese economy. In my opinion, this report demonstrates that investors and Canadian businesses should pay almost as much attention to China's economy as they do to the U.S. economy," said Alexander.

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