TD Bank Financial Group

Special Report

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TD Economics
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ASSESSING CANADA'S CURRENT ACCOUNT IMBALANCE

Are There Reasons for Canadians to Worry?

HIGHLIGHTS

- **As G20 discussions center on "global imbalances", we look at Canada's external balances.**
- **After a decade in surplus position, we forecast that the current account will stay in a modest deficit position of 2-3% of GDP through 2014.**
- **Factors behind the current account deficit aren't going away anytime soon. But, external financing needs look unlikely to surpass 3% of GDP on a sustained basis, compared to the 3.5-4.0% current account deficits recorded in the late 1970s and 1986-93. Further comparisons to the early 1990s show more differences than similarities - in particular foreign net liabilities as a share of GDP will remain much lower.**
- **Over the longer haul, this position is nonetheless unsustainable. The adjustment will likely occur through fiscal consolidation, a lower currency, and increased household savings.**

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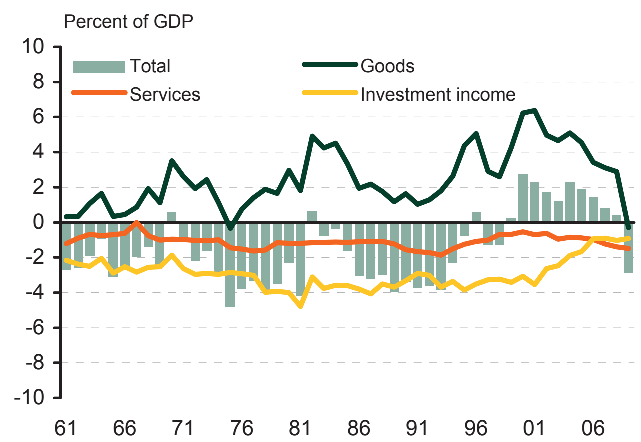
Last week, we published reports both leading up to and following the G20 meeting in South Korea, where discussions on global imbalances were at the core. The phrase "global imbalances" has generally been used as a moniker for the large and sustained international current account deficit of the United States in conjunction with large and sustained current account surpluses in China and a number of other developing economies. The focus has understandably been on these nations, given that they are the overwhelming contributors to the global challenge. But this is not to say that other economies around the world are not facing external imbalances, Canada being among them. Indeed, in recent quarters, Canada has been registering an international current account shortfall of around 3% of GDP – a fact that has not registered on the radar screen partly given the country's relatively small share of total world output and trade flows.

This raises the question of whether Canadians should care. Deficits need to be financed in some way. Students of Economics 101 will recall that in the case of the international current account, the financing is in the form of inflows of foreign capital (see text box on page 2). In the 1980s and 1990s, the challenges surrounding Canada's current account actually moved to the media headlines, when large structural shortfalls put Canada at the whim of international investors who became uneasy about mounting government deficits. This resulted in a "day of reckoning", when the Canadian dollar fell under substantial pressure, necessitating the need for the Bank of Canada to hike interest rates in defense and for governments to take bold action on massive deficits. This begs the question whether the current flow of current account red ink could lead to similar economic hardship down the road.

CANADA CURRENT ACCOUNT BALANCE



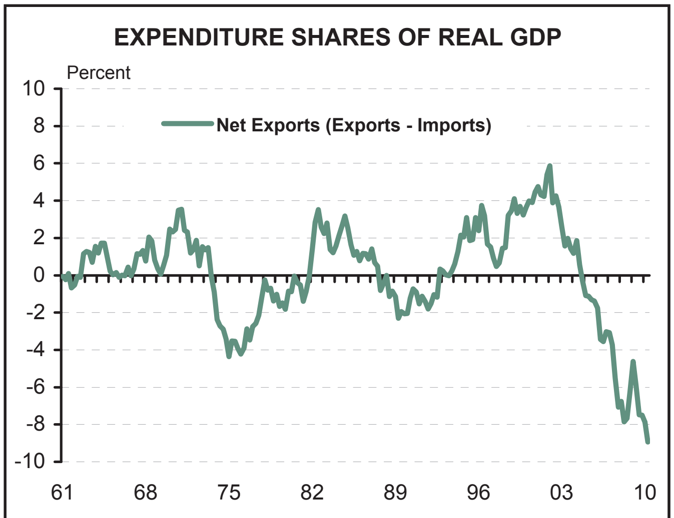
Source: Statistics Canada / Haver Analytics.

In this report, we argue that Canada's current account deficit position should remain manageable over the medium term, mitigating the risk of repeating the mid-1990s scenario. The current account deficit is projected to remain relatively steady at about 2.5% of GDP through 2014 – below its peak of 4% levels of two decades ago and well the peak U.S. level of 6.5%. Perhaps more importantly, Canada's net reliance on the stock of foreign capital, which stood at 12% of GDP in Q2/2010, is likely to remain considerably lower than in the 1990s, when net foreign liabilities surged to near 45% of GDP. Hence, the bigger risk for Canada stemming from external imbalances will continue to lie outside the country's borders. Put another way, as a small open economy Canada would get caught in the crossfire if persistent global imbalances impede the global recovery and/or financial markets down the road.

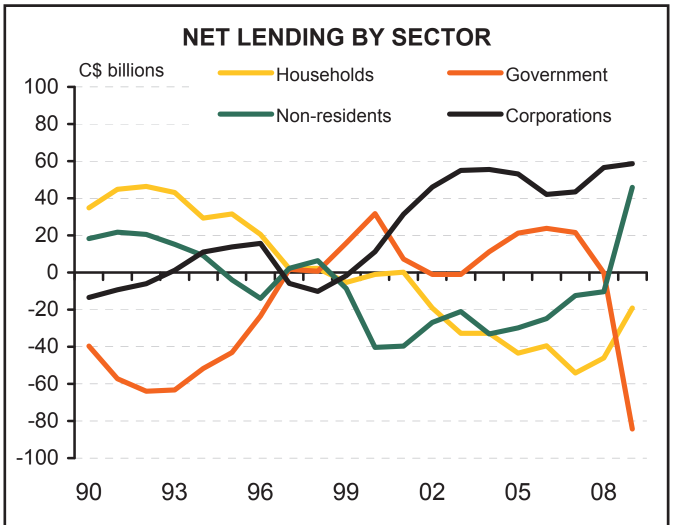
Over the longer run, however, even a moderate current account deficit cannot be sustained indefinitely in Canada. At the conclusion of this report, we touch on some factors that are likely to help restore balance in the future, including a lower Canadian dollar as well as a sustained improvement in the national savings rate, reflecting both increased savings by households and less dissaving by governments. While a good part of this adjustment is likely to naturally take shape, it could be facilitated by some active moves by Canadian governments – such as increased diversification of international trade and measures to boost pension savings – could assist in the longer-term adjustment.

The recession put an end to "twin surpluses"

The G20 summit discussion focused on the persistent global imbalances registered in many parts of the world over the last decade. Canada, too, has been registering imbalances on the international current account for many years. Deficits in the 1980s and 1990s were replaced by surpluses for the better part of the past decade, reflecting strong export gains to the United States and the commodity price boom that increased the value of Canadian exports of



Source: Statistics Canada / Haver Analytics.



Source: Statistics Canada / Haver Analytics.

resources to countries around the world. Since the global financial crisis hit in mid-2007, the current account balance started to slip towards a deficit position.

When the global recession hit, Canada was the only surplus running nation among the advanced economies to fall into a shortfall position. Other nations, such as Germany and Japan, managed to maintain current account surpluses in part because of their lower reliance on the U.S. market and commodity prices, along with higher household savings rates. In contrast, about 80% of Canadian merchandise exports were destined to the U.S. market in 2006, just prior to the U.S. recession. What's more, about a third of Canadian exports are in commodity-based industries, well above the average of the G20. So, when the U.S. economy faltered badly and commodity prices tanked, Canada's trade balance went from sizeable surpluses in merchandise trade to modest deficits. In addition, a previously improving investment income balance ground to a halt, stagnating around a $14 billion annual deficit since 2006.

However, Canada's recent external woes cannot solely be explained by an over-reliance on U.S. trade. The headline trends also mask sizeable imbalances in savings vis-à-vis investment that have emerged over the past three years. Since 2007, Canadian governments have swung from net savers to sizeable net borrowers, reflecting a cyclical revenue downturn and extra stimulus spending during the recession. Moreover, increases in household savings during the recession have been insufficient to finance the boom in housing-related borrowing in a low interest-rate environment. Corporations in Canada have ramped up their savings as profits have rebounded. But, this growing pool has not been enough to fully offset dissaving elsewhere.

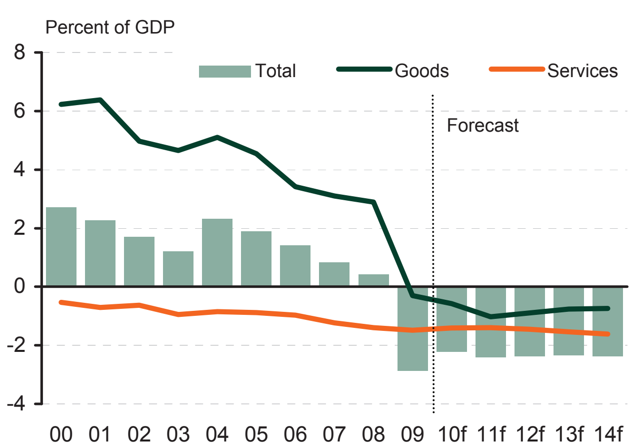
Perhaps surprisingly, the rebound in the U.S. economy and in commodity prices has put barely a dent in Canada's current account deficit over the past year, which likely hovered near 3% of GDP in the third quarter. The lack of significant improvement in the midst of a recovery reflects a lockstep strengthening in Canadian domestic spending. Notably, in recent quarters, Canadian businesses have been investing heavily in machinery and equipment, the bulk of which is imported. While a long-run positive for the economy, this uptick in investment has not been met by a material improvement in household or government savings.

Normally, a substantial deterioration in the current account tends to be accompanied by currency depreciation. But the opposite has been true over the past year. The U.S. dollar has been under downward pressure against most currencies, and most U.S. dollar-priced commodities have appreciated. Moreover, a relatively stronger domestic economy and higher interest rates than Stateside have been an attractive lure for foreigners. The bulk of foreign capital inflows has been concentrated in debt securities. Thankfully, given the contrasting fiscal fundamentals to other countries and Canada's own situation that prevailed two decades ago, non-residents look set to continue financing Canada's reasonable current account deficits without so much as blinking an eye.

TD Economics outlook through 2014

Using our baseline medium-term macroeconomic forecasts, we project Canada will remain in a current account deficit position through 2014. The main drivers behind the current account deficits aren't going away anytime soon. In a sense then, after a decade long run of surpluses – whereby

CANADA CURRENT ACCOUNT BALANCE



Source: Statistics Canada / Haver Analytics.

A primer on external balances

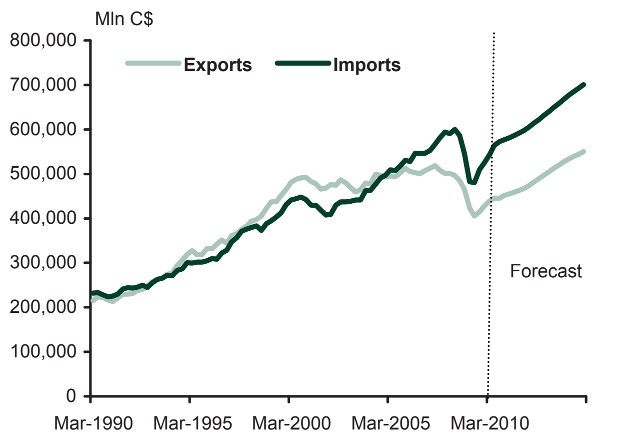
A country's economic and financial transactions with the rest of the world are recorded in its international balance of payments. In particular, a country's current account records its international balance in goods, services, and investment income. Viewed in this light, a nation that runs a deficit is not generating sufficient income from its exports to covers its import purchases – and must, therefore, borrow from abroad to cover the shortfall. The accumulation of current account deficits thus represents non-residents' buildup of claims on residents' assets. The converse is true for a surplus, which indicates that a country is a net lender to the rest of world. In this latter case, a country's residents accumulate claims on foreign assets.

An alternative way to look at a country's external balance is that domestic savings aggregated across the government, corporate, and household sectors are not sufficient to cover aggregate investment in an economy. Once again, a country with insufficient savings needs to import capital from the rest of the world. For example, if governments run large systematic budget deficits, other sectors must save enough to offset this borrowing in order to avoid a structural shortfall in the international current account.

Viewed either though its international trade or domestic savings generating capacity, one readily sees that a nation running persistent deficits relies on the rest of the world's ability and willingness to finance them. The more open, secure, productive, and wealthy an economy is, the greater will be its capacity to offer foreigners a decent enough return to secure financing. For a small economy like Canada, the rest of the world's ability to finance its external deficit is not in question. Effectively, however, a small economy's ability to borrow from non-residents has its limits. Because it competes in the global savings pool with alternative assets and investments in other countries, the binding constraint is foreigners' willingness to invest. This in turn relies on the CA deficit not getting so large as to compromise a nation's ability to honour its liabilities.

How large is too large? A precise threshold figure is difficult to determine. Moreover, the specific sources of any current account deficit matters just as much as its magnitude. For example, it is one thing if a country is externally financing productive long-term assets, i.e. "good debt". It is quite different if it merely reflects borrowing to consume. Nonetheless, that being said, historical experience suggests that sustained and growing current account deficits in excess of 4-5% of GDP tend to erode foreigners' confidence and willingness to continue financing such deficits. The bottom line is that while small nations may need net capital inflows to improve their standard of living, they should be weary of letting current account deficits become so large as to test the limits of sustainability. Redressing a current account imbalance cannot happen overnight, so avoiding a crisis requires a long forward-looking view.

CANADIAN MERCHANDISE TRADE BALANCE



Source: Statistics Canada. Forecast by TD Economics, Sept. 2010

Canada was a net lender to the rest of the world – the country has reverted back to its more traditional position of being a net borrower.

From the export income perspective, this means that Canadian revenues from goods sold abroad are not expected to be large enough to fully finance our imports of goods and services, combined with our investment income deficit. We forecast that the current account balance will stay in the vicinity of -2.5% of GDP during the forecast horizon. On top of the typical deficits Canada usually incurs in services trade and investment income, the nation's merchandise (goods) trade balance is expected to remain in deficit position, with an annual magnitude near 1% of GDP over the next five years.

Four important assumptions underlie this forecast. First, improvements in U.S. growth and demand are expected to remain subdued over the next several years, with the U.S. economy not likely to return to full capacity until 2014. Second, we don't believe commodity prices are likely to gain further significant ground in light of our expectation of only moderate global growth and prospects for some stability returning to the USD by next year. Third, the Canadian dollar is likely to hold near or above parity over the next few years. And fourth, prospects for Canadian machinery & equipment spending remain strong. This development, combined with ongoing two-way trade with the U.S., is likely to keep import growth well supported.

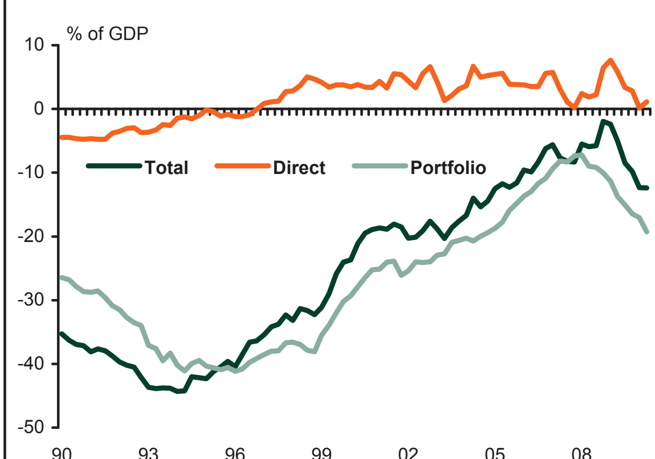
Beyond the goods deficit, the other two components of the current account – services and investment income – also appear unlikely to tilt into surplus position. Canada's services deficit is largely structural. Services include travel, transportation, government, and financial intermediation activities. The largest components are travel and transportation, and mostly reflect Canadians travelling abroad more than foreigners travel to Canada. This preference looks unlikely to reverse. Meanwhile, a high Canadian dollar against the U.S. dollar, Euro, British Pound and most currencies will do nothing to redress the balance of travel.

Viewed through the savings / investment lens, an important driver of the recent current account reversal has been dissaving by governments and households. Both will improve their net savings positions, but this will occur only gradually, especially in this low interest rate environment. Moreover, this will be partly offset by lower corporate savings. The latter are currently sitting at record highs and are expected to be put to productive use at home and abroad in the years ahead. A forthcoming report by TD Economics will detail the Canadian business investment outlook.

Are current account deficits a cause for concern?

As noted earlier, the last time Canada dealt with a persistent current account deficit was back in the 1980s and early 1990s. While there was a dearth of savings across the economy, massive government deficits were the big concern. Indeed, the current account deficits coincided with large combined federal and provincial government deficits totalling 8% of GDP in the early 1990s for instance - compared with less than 5% today. This was also before the impact of the U.S.-Canada FTA (1989) and NAFTA (1994) really began to propel Canadian trade to the United States. Commodity prices had also succumbed to disinflation during much of that period. Canada was running a massive merchandise trade deficit and increasing shortfalls in ser-

CANADA NET FINANCIAL INVESTMENT POSITION

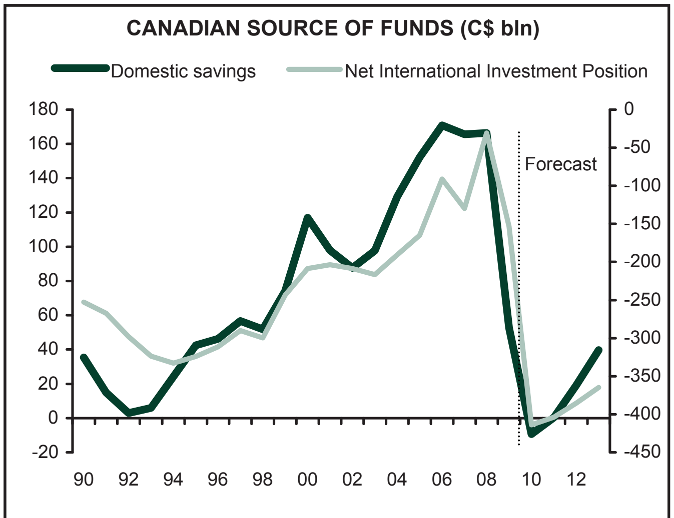


Source: Statistic Canada / Haver Analytics.

vices and net investment income. As Canadians might recall, this period did not end well The international press started to turn its attention on Canada's large twin deficits, with the Wall Street Journal infamously referring to Canada's currency as the Mexican Peso of the North. The Bank of Canada raised interest rates by a full percentage point to staunch the bleeding in foreign investment flows. Household borrowing rates were affected. These events were a major catalyst in encouraging the nation and the federal government at the time to take action to rein in the root cause of the external account imbalance – government deficits.

This raises the question whether Canada is headed for a similar day of reckoning. While there are some similarities, there are more differences:

- As we have discussed, Canada's current account deficit will not likely reach the same heights as in the 1990s. It should remain below the 4% levels that have traditionally been tied to current account problems.
- More importantly, the country's reliance on foreign capital will remain considerably lower. Canada's net international investment position stood at -12% of GDP as of Q2/2010, compared to -45% in 1993. Going forward, as domestic savings climb, the country's net international investment position should partly recover some of its lost ground. Moreover, reliance on gross foreign portfolio flows (i.e. "hot money") is expected to stay about one percentage point lower of GDP than in the early 1990s.
- Canada stood out as a risk in the 1990s. But, in current times, it has been and should continue to be viewed as a relatively strong place to invest. Interest rates should remain higher than the U.S. over the next few years. The Potash deal saga notwithstanding, a recent piece by our colleagues at TD Securities argues that foreign portfolio investment remains unaffected. Direct investment (FDI) has grown at a solid 7% average annual clip over the last decade, both a strong indicator of prevailing investment opportunities and investor sentiment.



Source: Statistics Canada. Forecast by TD Economics.

Bottom Line

All that being said, any imbalance is concerning. No immediate trigger is required to redress the modestly-sized imbalance. While Canada is facing a persistent current account deficit, it is expected to remain moderate at 2-3% of GDP over the next 3-5 years. We do worry that if households and governments don't begin to improve their savings positions – as they are predicted to – the situation will deteriorate. In particular, the low interest rate environment could lower incentives to reduce borrowing. From a long-term perspective, large current account deficits are not sustainable.

Governments' deficit-eliminating efforts will be key to stemming the net borrowing requirements of the nation. Hence, much the external balance adjustment will likely take shape by way of fiscal consolidation. Other adjustment factors will include increased household savings and a currency eventually returning closer to fair value of about 85-90 U.S. cents. While much of the adjustment should take place naturally, some policy actions beyond deficit reduction may be needed to help to facilitate the transition. Expanding international trade opportunities and measures that boost domestic savings – from financial literacy to tax incentives – should be at the top of the list.