

CANADA WILL NOT ESCAPE ECONOMIC MALAISE OF THE U.S.

- U.S. economy slated for a recession in 2008
- Real GDP growth expected to be a dismal 1.1 percent in both years, 2008 and 2009
- Canada will produce equally soft headline GDP growth of just 1.1 percent in 2008 but rebound modestly to 1.8 percent in 2009
- Provinces – particularly Ontario – with a heavier manufacturing base and, in particular, low net exports of high-demand resource products, will be hit hardest.

TORONTO – Canada will not escape the economic malaise that is underway in the United States according to the March issue of the TD Quarterly Economic Forecast. And, the American contraction will widen regional divides in Canada.

According to Chief Economist, Don Drummond: “The west will remain in the best shape to weather the economic headwinds, while central Canada – and notably Ontario – will be in the worst.”

Going south

Until recently, economic indicators suggested the United States could potentially skirt a recession. This view is now in question given the broad-based nature of jobs losses in each of the first two months of 2008.

Ten of 15 industries posted year-to-date losses in jobs in January and February. The 6-month annualized change in private sector employment dropped to 0.1 percent. There are no instances since the 1960s when this indicator decelerated to this level without a recession ensuing within one to three months.

The house is not a home

The last two months have also revealed more bad news about the housing downturn. Existing home prices have fallen for an unprecedented 18 months and high inventories suggest a reprieve is not in sight.

Never before have Americans owned less of their homes, as equity dipped below 50% in 2007 for the first time since the Federal Reserve started tracking the data in 1945. Drummond noted “this presents several threats to the economy and consumer spending. Among them is the rise of the so-called ‘mortgage walker’ who can afford their payments but decides not to pay.” This action would increase loan losses among financial institutions, which, in turn, would lead to more cautious lending behaviour.

Necessary evil

The 2009 outlook is more promising. “The adjustment underway in the U.S. is a necessary evil that will allow lenders and homeowners to work through oversupply, stagnating home prices, and the excesses of past lax lending standards” commented Drummond. This will lead to fewer restraints in consumer spending and lending behaviour, allowing consumer spending to sustain a convincing recovery by the fall of that year.

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A narrow escape

U.S. troubles will continue to wash onto Canadian shores, contributing to modest 1.1 percent economic growth in 2008. Two direct linkages between the countries will continue to harm the domestic economy.

First, the current tightness in the credit cycle will act as a speed bump to investment by raising the cost of funding and restricting investment for a number of Canadian companies. Second, the lethal combination of a high Canadian dollar and weak U.S. demand will continue to drag export growth. In fact, exports are expected to contract outright in the first half of the year extending the massive loss in shipments that ended 2007 in dramatic fashion.

A tale of two economies

The weakness in the trade sector will not be evenly distributed among the provinces and the pattern will reinforce the east-west divide that Canadians have become all too familiar with in recent years.

The province of Ontario is slated to absorb the biggest negative trade impact. The economy is expected to eek out 0.5 percent growth in 2008, the worst showing since 1992. At the opposite end of the spectrum, Saskatchewan will outperform national growth by nearly threefold.

Trading places

Canada's regional divide can largely be explained by trading patterns. TD estimates that the U.S. export share of GDP by province ranges from a high of 40 percent in Ontario to a low of 18 percent in British Columbia.

The sector mix is equally important. "Since the U.S. recession is consumer-led, related shipments will be hardest hit within the provinces, particularly auto and forestry products" noted Drummond. Not surprising, Ontario is expected to post the worst economic performance in large part because one-third of its total international exports are attributed to shipments of automotive products.

In contrast, even though British Columbia has a similar share of its exports in forestry-related products, the impact on that provincial economy is mitigated by its relatively low overall reliance to U.S. trade. Declining U.S. forestry demand will impact New Brunswick and Quebec, but again, their exposure is relatively low at 5-7 percent of total exports.

Some export areas are likely to hold up relatively well in 2008, including energy, other non-forestry commodities and agriculture. This is partly why Saskatchewan will be at the top of the leader board in 2008, as two-thirds of its exports are related to energy and/or refined products, wheat and oil seeds crops. Another 10-20 percent is related to non-energy materials.

Domestic spending levels are holding strong. However it is unreasonable to expect them to be completely immune to the growing pressures on provincial export sectors. By the second quarter of this year, employment in central and eastern Canada is expected to flatten out, leading to some increase in unemployment rates and some easing in consumer spending and housing activity. As a result, Ontario will barely keep its head above water, while expansions in Quebec and other eastern provinces fare slightly better, at 1-2 percent.

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At last, good news

“Cooling domestic demand growth in Canada won’t change the fact that the underpinnings are day and night relative to its US counterpart” remarked Drummond. Among the differences, Canadian housing markets are flourishing, while consumers are already benefiting from past fiscal stimulus and strong income growth. These factors won’t come apart at the seams in 2008, especially when an additional 150 basis points in monetary stimulus of central bank cuts is added into the equation. As such, Canada remains fundamentally sounder than the U.S.

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