TD Bank Financial Group

TD Economics

Special Report

October 27, 2006

IN THE SHADOW OF THE U.S. SLOWDOWN: LOCAL CONTEXT KEY TO GLOBAL GROWTH

The defining feature of the global economy over the next four to six quarters will be the U.S. slowdown and recovery. It's no secret that when it comes to global growth and downturns the major industrialized nations increasingly dance to the same tune. In the mid-1980's and mid-1990's, when the U.S. experienced mid-cycle slowdowns, growth similarly slowed in Canada, Japan, and Europe with varying lags. Encouragingly, no major economy experienced a recession during either of these slowdowns and, in fact, global economic growth outside of the U.S. actually accelerated in both cases.

The forthcoming period of U.S. economic weakness is unlikely to be any different. TD Economics forecasts that world economic growth will slow by one percentage point from 5.0% in 2006 to a still strong 4.0% in 2007. The mellowing U.S. consumer will be responsible for knocking 0.2 percentage points off global growth through diminished imports and an additional 0.1 percentage points in lost impetus through forgone profits from foreign companies' operations in the U.S. Adding in the additional 0.2 percentage points lost from the U.S. itself as economic growth there slows from 3.4% in 2006 to 2.4% in 2007, this would lead global growth in 2007 to slow only to 4.5%. The remaining half a percentage point lost in 2007 is unrelated to the U.S. slowdown, highlighting the fact that the local context will govern global performance.

For this reason, the present report focuses on some of the potential risks to the domestic resilience in these regions. Their performance in turn tends to have an impact on nations with whom they have close ties. This offers the unique potential to offset a moderate U.S. slowdown. How likely this is to happen depends less on the slowdown itself, and more on existing domestic conditions and how policymakers respond. These responses will be key as the world slips into the shadow of the American slowdown.

HIGHLIGHTS

- **One-half of the slowdown in global growth is unrelated to the United States economy.**
- **Major markets outside the U.S. and Canada are on solid footing heading into the global soft patch; however, they are ill-balanced to increase momentum and take on additional slack to compensate as the U.S. economy slows.**

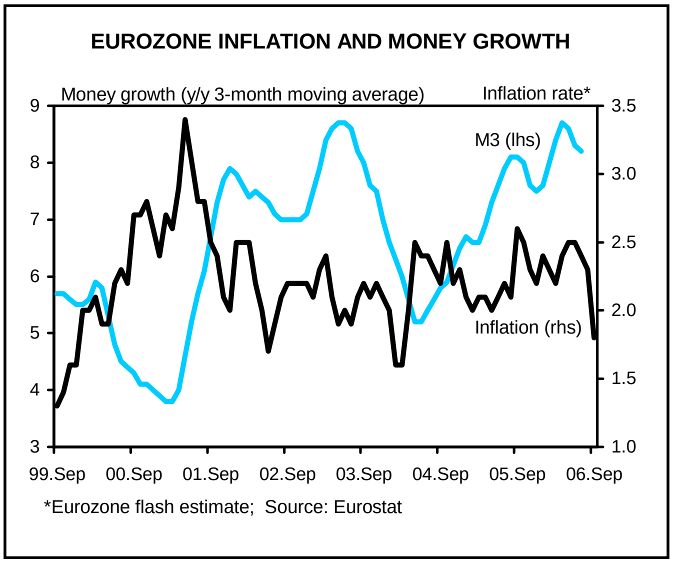
WORLD ECONOMIC OUTLOOK
Annual per cent change unless otherwise indicated

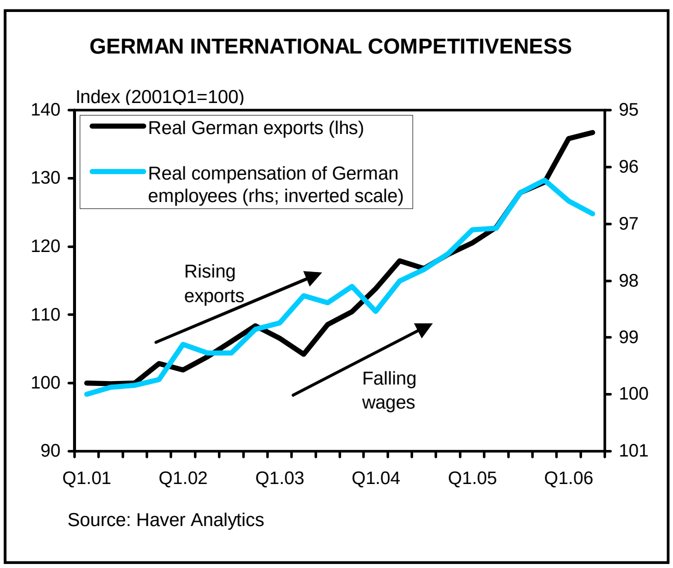
Real GDP	2005 Share	2005	Forecast 2006	2007	2008
World	100	4.8	5.0	4.0	4.8
U.S.	20	3.5	3.4	2.4	3.6
Canada	2	2.9	2.8	2.3	3.2
Remaining Americas	7	4.2	4.6	3.2	4.1
EU-12	15	1.3	2.3	1.4	2.3
U.K.	3	1.8	2.5	2.6	3.1
Remaining Europe, Middle East, and Africa	12	5.5	5.6	4.6	4.4
Japan	6	2.6	2.7	2.0	3.1
China	15	9.9	10.3	9.0	9.8
Remaining Asia	19	5.3	5.0	4.5	4.9

TD Economics forecast as at September 2006

EU – pay now, grow later

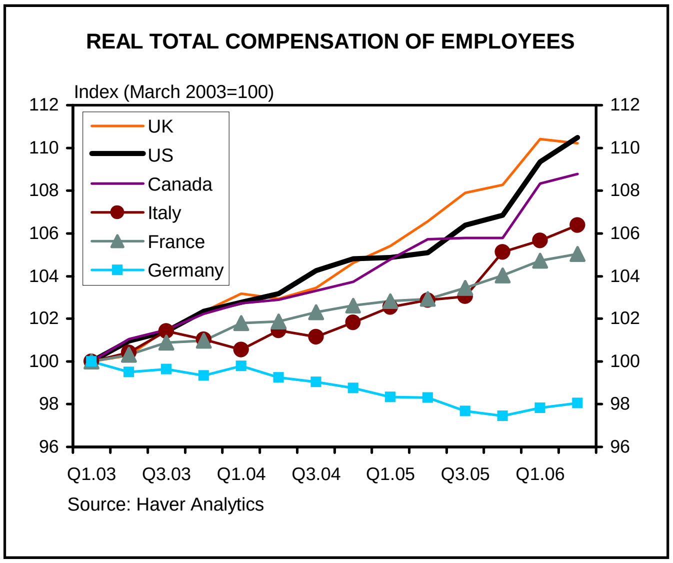
The birthing pangs for the Eurozone have passed, and adolescence has shown the potential for growing strength. After a lackluster 2005, the Eurozone has been enjoying an investment-led boom, with growth through the first half of 2006 moving at its fastest clip since 2000. Productivity growth, coupled with efforts to constrain costs, have fueled exports, especially in global export leader Germany. While moderating global demand will present challenges in the coming quarters, these challenges will be softened by easing commodity prices and the brief nature of the expected slowdown. In fact, most of the pullback we expect in overall growth in the Eurozone for 2006 will be a mix of needless self-inflicted pain courtesy of monetary overtightening together with responsible fiscal reforms which will boost potential growth in the future.





The European Central Bank (ECB) will play a pivotal role. Year-over-year headline inflation eased from 2.3% to 1.8% in September, and is now near the ECB's "less than but close to 2 per cent" target. The ECB, however, also targets money growth (M3) directly as part of its twin pillars of monetary policy. M3 is a broad measure of money, which includes cash held by individuals as well as by banks. As banks lend the cash they hold in deposits, the money supply increases. This causes inflation if the process of money creation exceeds the underlying growth in the real economy. In the Eurozone, consumer credit growth has quadrupled in three years, corporate borrowing is growing at its fastest pace ever, and growth in lending to households for home purchases is still rapid but decelerating . This has led M3 growth to accelerate to an 8.2% annual pace in August. While coincidently this is roughly the same pace as in Canada right now, the ECB has cited it as a risk despite the fact that there has been little discernable pass-through into inflation. As a result, financial markets now expect the ECB to raise rates one more time this year and possibly further next year. The ECB has failed to meet their M3 target since inception, so it's difficult to say how effective or determined they will be in the future but there are three potential risks. The first is that since the effect of each interest rate increase will take 12-18 months to work its way through the economy, there is a real danger of over-tightening. Secondly, given that investment spending accounted for over two-thirds of Eurozone growth in the second quarter of 2006 and one-third of growth over the last year, higher interest rates may quash its most vigorous sector. Thirdly, there are concerns consumer demand may not be robust enough to withstand higher interest rates. While recent consumption growth for the Eurozone has been moderate, the level of consumption in the largest continental economy, Germany, has not grown in five years.

Meanwhile, fierce global competition has restrained Eurozone wage growth and savings have fallen to support what spending there has been. Despite rapidly growing housing wealth in many European countries, the difficulty of borrowing against one's home equity in such large markets as Germany, France, and Spain hinders consumers from spending more. These prospects have started to weigh on some of the forward-looking indicators. The consumer and business outlook appears to have peaked, while in the European bond market, yield curves have been flattening



– a signal of slower growth ahead.

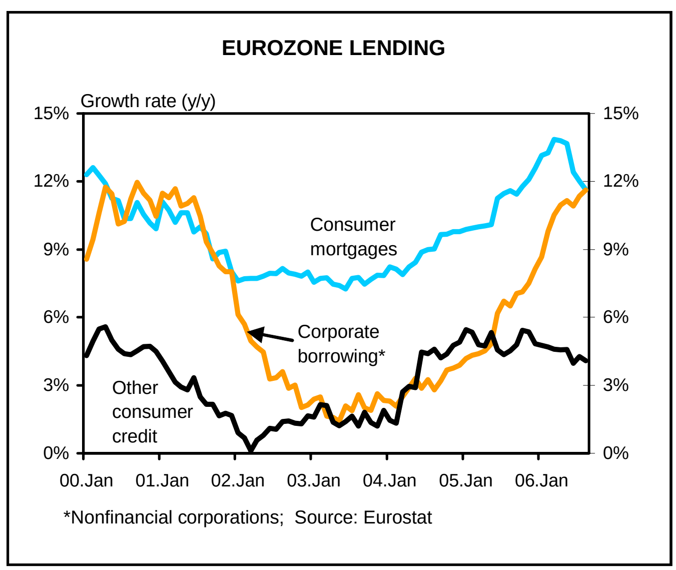
Driving some of the dampened economic outlook is a tightening in fiscal policy which will reduce near-term economic growth but offer prospects for a more robust economy in the future. All Eurozone members are supposed to limit annual government borrowing to no more than 3 per cent of GDP; however, numerous countries have failed to meet this criterion year after year. Preliminary Italian budgets suggest the government may reduce spending by as much as one and a half percentage points in 2007 in order to fall below the 3% threshold. Germany announced they will meet the target in 2006, one year ahead of schedule, yet will go ahead with an increase to their value-added tax of three percentage points on January 1, 2007, which will shave about three-quarters of a percentage point off 2007 real GDP growth. The impact of the contraction in fiscal policy across Europe may be further exacerbated if the ECB decides to raise interest rates further, as higher taxes induce higher prices. ECB tightening would not be helpful, but fiscal consolidation, if successful, will prove a one-off drag on economic growth in 2007, but will promote faster future economic growth through reduced debt service costs, lower interest rates, and a higher level of private investment.

It is precisely because they lack many of the Eurozone's structural problems that the United Kingdom is poised to outperform its continental cousins. The Bank of England is likely to raise their policy rate to 5.00% in November in the face of a robust consumer base fueled by the strongest wage gains among the major European economies and decade-high employment in the service sector. While several continental economies face the risk of housing bubbles, the U.K. housing market has already corrected and is once again growing at a healthy pace. Moreover, with a mortgage market more akin to that of Canada and the U.S., home equity withdrawals in the U.K. average 2% of after-tax income per year and have a larger bearing on consumer spending than in any other EU member.

China – time waits for no man

China's response to the U.S. slowdown will be coloured by their desire to maintain a stable expansion and continued employment growth. China's policymakers have meticulously and successfully managed the details of economic development for some time in their quest to accomplish in decades what took a century in the U.S. and Canada. Over the last decade, the annual growth rate of the Chinese economy has averaged 9%, a notch slower than the 10% average seen in the two prior decades. These earlier decades saw wide swings, however, with the real growth rate fluctuating between 4-15%, as opposed to 8-10% in the last decade. The authorities see a growth rate between 8-9% for the economy as sustainable, and more importantly, as a crucial factor in maintaining economic, political, and social stability.

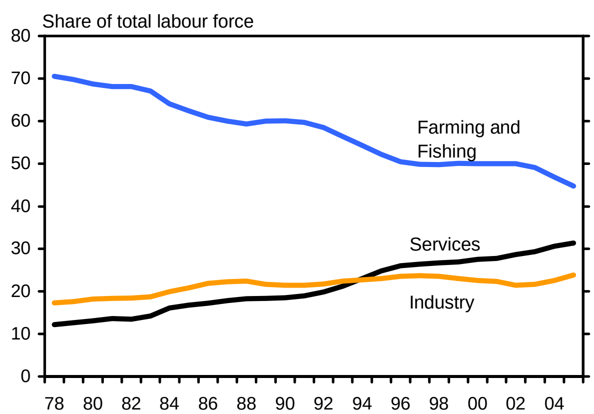
Income inequality, though, jeopardizes that stability. Nearly six in ten Chinese live in rural areas, with the majority earning their living through subsistence farming. Export-oriented urban centres, meanwhile, attract workers from these rural areas and drive Chinese wages and inflation up. To date, Chinese inflation has been reported



to run about 2% lower than in the U.S. But with 60 per cent of the population only marginally sharing in the gains from growth, any inflation can prove politically costly as rural households' expenses grow faster than their earnings. To remedy this situation in the long-run, central government plans call for 300 million people – the equivalent of the entire U.S. population – to move from the rural areas to urban centres over the next two decades, bringing rural population shares in-line with those in the U.S. and Canada. In fact, it is not output growth, per se, that authorities are eager to maintain, but employment growth. In the first half of 2006, one million new jobs were added each month, about 20 per cent faster than the pace in 2005. Meanwhile, pricing pressures continue to build and the government is left with subsides and price controls which become more expensive to maintain the larger the wedge between urban and rural prices becomes.

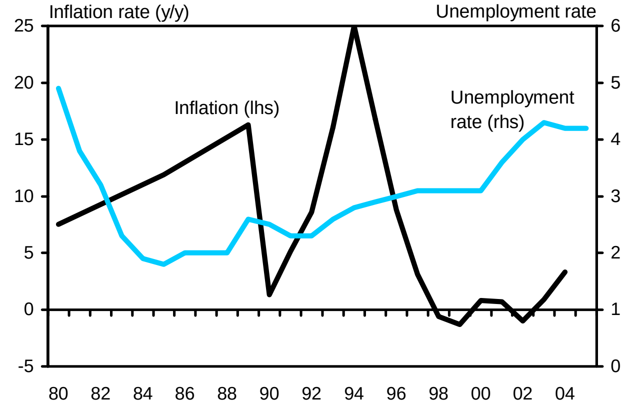
The more pressing disconnect for Chinese policymakers lies in the financial sector. The Great Wall of China may have successfully kept out the Mongol armies, but Chinese attempts to wall off financial flows have resulted in mounting pressures on the central bank and domestic banking system as a whole. The authorities' actions are not necessarily misplaced. Experience in developing countries shows a negative relationship between inward capital flows and growth performance. In other words, those countries which have attracted the most foreign investment have also, on average, experienced slower rates of economic growth. It is not entirely clear why this has been the case, but one possible explanation is that underdeveloped banking systems in many developing countries tend

CHINESE LABOUR FORCE BY SECTOR



Source: China National Bureau of Statistics

CHINESE URBAN INFLATION AND UNEMPLOYMENT

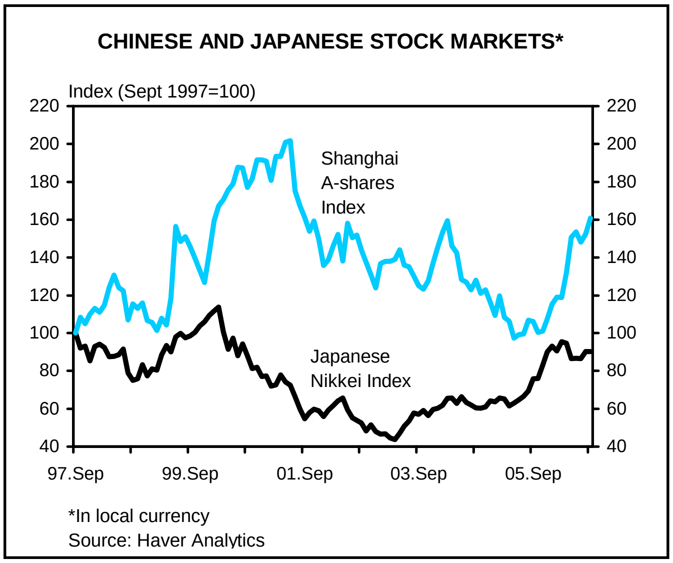


Source: China National Bureau of Statistics

to inhibit economic growth. Those countries with well-developed banking systems – secure consumer deposits, efficient lending, liquid stock and bond markets, futures and other hedging tools to manage inflation and foreign exchange risk, accounting services, bankruptcy laws, etc. – have largely been spared this fate. While China prefers domestic banks develop these services, progress has been slow and their recent decision to allow the first foreign bank to provide renminbi-denominated financial products is a sign of the importance the authorities place on speeding this process up.

The Chinese stock market has also floundered in recent years as the authority's desire to maintain strict control and stability has been directly at odds with an efficient stock market. After reports of corruption surfaced in IPO sales in the 1990s, authorities required that two-thirds of any new shares issued be non-tradable shares held by the state. This insulated share prices from competitive pricing as the shares held by the government – nearly two-thirds of market capitalization in 2006 – were seen as a tool to ensure stable employment, rather than increasing productivity. As a result, the domestic Chinese stock market (A-share market) averaged an annual loss of 12.6% a year from 2001-2005. Repeated heavy-handed approaches to remedy this situation failed until a resolution in 2005 led to agreements to convert four-fifths (in market cap) of these non-tradable shares into regular shares. As a result, the A-share market is up more than 50% (in local-currency terms) in the first nine months of 2006.

Nevertheless, time waits for no man. Chinese reluctance to allow greater exchange rate appreciation does



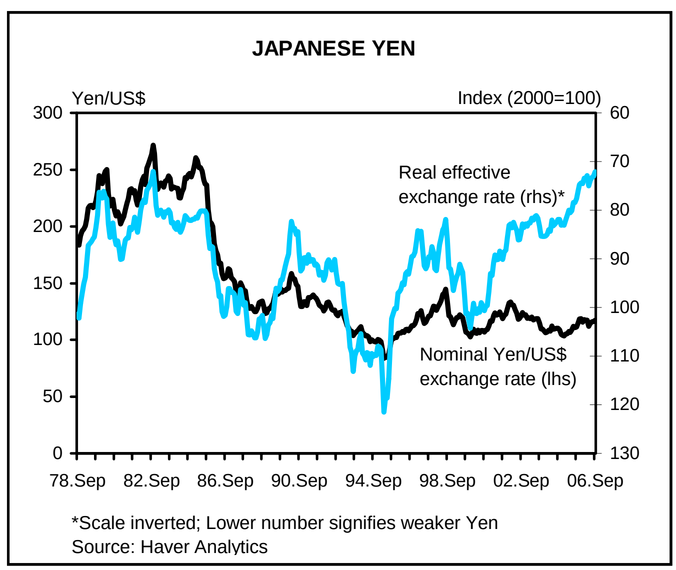
stimulate employment growth, by making their exports cheaper, but at the expense of fueling inflation as well as kindling protectionist sentiment abroad. The U.S. Congress recently stepped back from threats to impose a 27.5% tariff on all imports from China, while the EU went ahead with a 16.5% tariff on shoe imports from China. As global growth slows, Chinese authorities may be even less inclined to allow the exchange rate to appreciate in order to avoid a double whammy of falling demand and rising prices for their exports. This would likely further fan the flames of protectionism. Meanwhile, Chinese foreign exchange reserves will shortly top US$1 trillion. This is a direct result of their management of the exchange rate. While a small portion was used to recapitalize ailing domestic banks, these reserves only have limited productive uses. In addition, since two-thirds of these assets are held in U.S. dollars, they will lose value when and if the renminbi is allowed to appreciate. Chinese authorities are thus hard-pressed to balance their preference for managed growth with the reality that they can't control everything.

Japan – 3…2…1½…1¼...1...Liftoff?

Liftoff for the Japanese economy is premised on a clean break with its economic past. We believe the prospects are good Japan will once and for all make just such a break, with Japanese economic growth easing from the 2.7% pace expected this year to 2.0% in 2007. Unlike the sizeable slack expected to build in the Canadian and U.S. economies, 2.0% is roughly the potential growth rate for the Japanese economy without causing undue inflationary pressures. We therefore expect the Japanese economy will continue to run on all cylinders.

The concern has been the fact that Japanese consumer prices are unchanged from their level in 1993. In other words, inflation has been nonexistent for over a decade. This state of affairs fostered a general economic malaise that confounded repeated attempts to restore economic normalcy. But hope abounded for 2006: three years of accelerating growth, strong capital investment, and the Bank of Japan's (BOJ) first interest rate hike in six years declared the defeat of deflation. Furthermore, a weak inflation-adjusted (real) yen is helping to push export growth in the third quarter to its fastest pace in two years, in turn driving industrial production. While there has been a gentle weakening of the Yen/USD exchange rate for a little over a year, the lack of inflation in Japan relative to its trading partners has left the real exchange rate at its weakest level in over two decades. It is this real exchange rate, rather than the nominal, which drives trade flows. Nevertheless, while this same currency weakness may partially explain the contraction in Japanese imports currently underway, it also highlights the failure to date of the final stage of the ignition sequence – the consumer. While there is still hope everything will move according to script, soft spending and income data for July and August suggest consumption may contract in the third quarter for the first time in two years which is not very promising.

In light of this, Japanese policymakers privately welcome the weak yen, even if they're publicly hesitant to do so for fear of upsetting the U.S. This has also made monetary policy quite complicated. The Bank of Japan (BOJ)



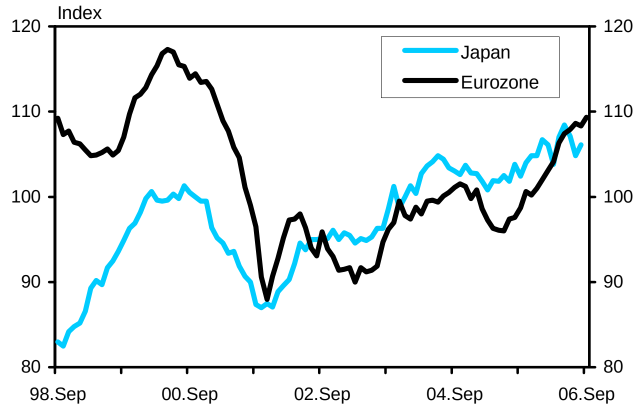
wants to avoid fueling an investment bubble with low interest rates and put some distance between the target interest rate and the zero-floor in order to give themselves some margin for maneuverability down the road. However, recent revisions to the CPI data showed deflation continued into 2006, and higher interest rates would only serve to further delay consumer spending, as well as lift the yen and lower exports. With early indications that capital spending may be moderating and unwinding inventories could weigh on growth in the near term, it is doubtful the BOJ will be able to raise rates before year-end, with a sizeable minority in the market not expecting another rate increase for at least a year.

The Japanese tea leaves are further clouded by a new government that recently took office. The Prime Minister himself has limited economic experience and, in fact, was criticized during his campaign for a lack of specificity on his economic plans. While his cabinet choices suggest a continuation of pro-market reforms, recent nuclear testing by North Korea could dominate much of the political agenda for the coming year. This is a risk should the economic situation unexpectedly deteriorate, but since public attention is fairly focused on the need to trim government debt and address long-term social security funding, this is of limited concern otherwise.

The Axis of Growth

In the web of global demand, who picks up the slack from a weakening U.S. economy is a peripheral concern, and indigenous factors are set to dictate the success of the international economy in riding out the current U.S. slowdown. While the EU, China, and Japan hold the greatest potential for carrying the torch forward, the pace of economic growth in all three appears close to cresting. Moreover, each is carrying its own unique vulnerabilities. Of the three, China has the greatest potential vulnerability to the U.S., with concern whether rural/urban and export/domestic imbalances will shake anything loose. This is

ECONOMIC SENTIMENT*



*Eurozone economic sentiment indicator and Japanese composite index of leading indicators. Source: Haver Analytics

balanced with entrenched stability and the insurance US$1 trillion in reserves provides. In the EU, the risks of monetary overtightening, fiscal contraction, and possible weakness in housing are balanced by the chance that investment and consumer spending prove resilient. Lastly, Japanese risks of a soft recovery and return to deflation are offset by the stimulative level of the currency and interest rates and optimism consumer spending might yet materialize. With the downside risks held in check, there will be enough juice in the global tank to coast through 2007 at a muted – but still strong – 4% growth rate. This will be one percentage point less than 2006 but still a full 1-1½ percentage points higher than the slowdown in 2001-2002. However, should the one-in-four chance of a U.S. recession materialize, the pace of world economic growth would slow by an additional 1½-2 percentage points in 2007 and 2008 relative to our current forecast. All things considered, the shadow cast from a U.S. economy, which is set to slow to a near 2% annualized pace of growth for the next four quarters, suggests that the global expansion will only temporarily moderate before picking back up in late 2007 and 2008.

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