Observation

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July 28, 2011

HIGHLIGHTS

- The U.S. debt ceiling debate has important implications for Canada's economy.
- In an accompanying piece we lay out four scenarios on how the debt ceiling issue could play out in the U.S. In this piece we explore what they could mean for Canada.
- In a best case scenario, the U.S. raises the debt ceiling and sets about on a credible deficit reduction plan. In this case, the Canadian economic outlook will be unaltered.
- If there is failure to pass a credible deficit reduction and the U.S. is downgraded, the Canadian dollar is likely to remain lofty, but likely not enough to further threaten Canadian growth.
- Should Congress fail to raise the debt ceiling by the deadline, U.S. economy could contract if it extends beyond a short period and Canada would see its growth pull down too.
- In the extreme case that the U.S. government misses a debt payment, the Canadian economy could be pushed back into recession.

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WHAT THE U.S. DEBT CEILING MEANS FOR CANADA

As the political debate around the U.S. debt ceiling enters the eleventh hour, Canadians watching on the sidelines are wondering what the crisis could mean to them. In an accompanying piece, we lay out a number of scenarios that could occur south of the border. In this report, we consider what the impact of these scenarios will be for the Canadian economy and domestic financial markets.

Briefly, the four possible scenarios we lay out for the U.S. are:

1) U.S. policymakers raise the debt ceiling before the deadline and attach to it a credible plan to cut deficits over the long-term;

2) The debt ceiling is raised before the deadline but the plan put in place to deal with the deficit does not pass the muster of at least one of the credit-rating agencies and the credit rating of U.S. sovereign debt is downgraded;

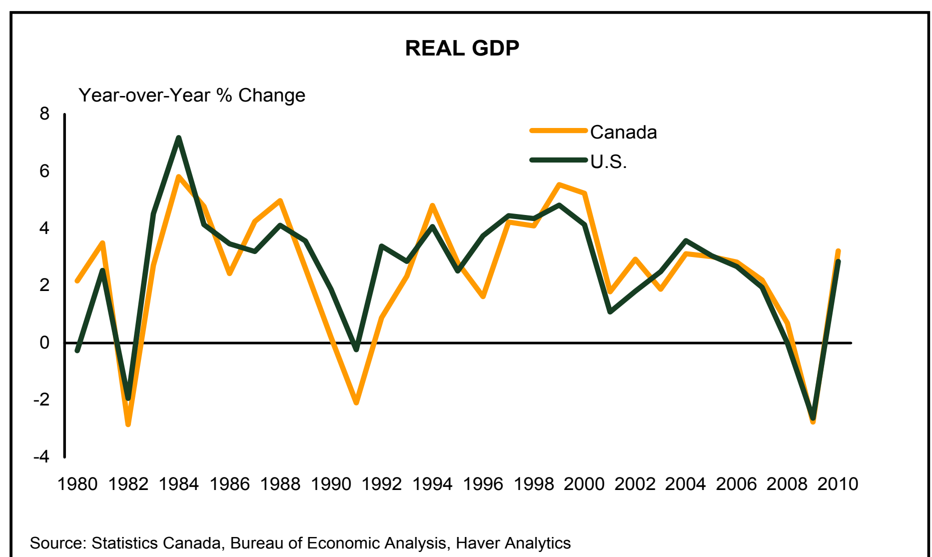
3) The August 2nd deadline is breached and the U.S. government begins prioritizing payments. In this event, interest payments continue to be made, but government spending is cut back dramatically and U.S. debt is downgraded;

4) No resolution of the debt ceiling combined with the financial strain caused by an extended period of revenue shortfalls causes the U.S. to miss a Treasury payment, placing it in technical default.

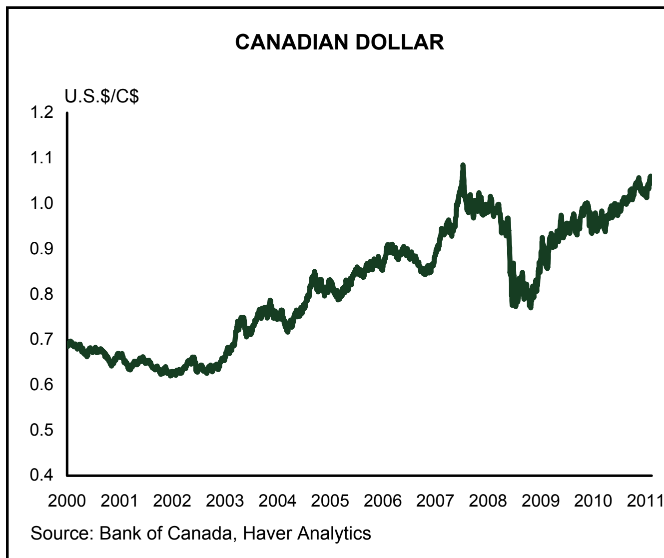
Scenario 1 - Business as usual

In the case that the U.S. raises the debt ceiling and sets about on a credible deficit reduction plan, the outcome for Canada is likely to be much like our base-case outlook outlined in the June Quarterly Economic Outlook. As a result of deficit cutting in the United States, economic growth Stateside is likely to trudge along at roughly 2.5% to 3.0%.

The Canadian economy, under this scenario, will continue to make a transition away from domestic sources of growth and towards business investment and exports. The Canadian dollar would likely remain strong, reflecting interest rate



Source: Statistics Canada, Bureau of Economic Analysis, Haver Analytics



differentials and an economy that is operating much closer to potential than its U.S. counterpart. However, the most recent increases in the Canadian dollar relative to the U.S. that has seen it push as high as US$1.06 would likely be unwound as uncertainty about the U.S. situation diminishes.

Scenario 2 - Ceiling raised in time, but U.S. rating downgraded

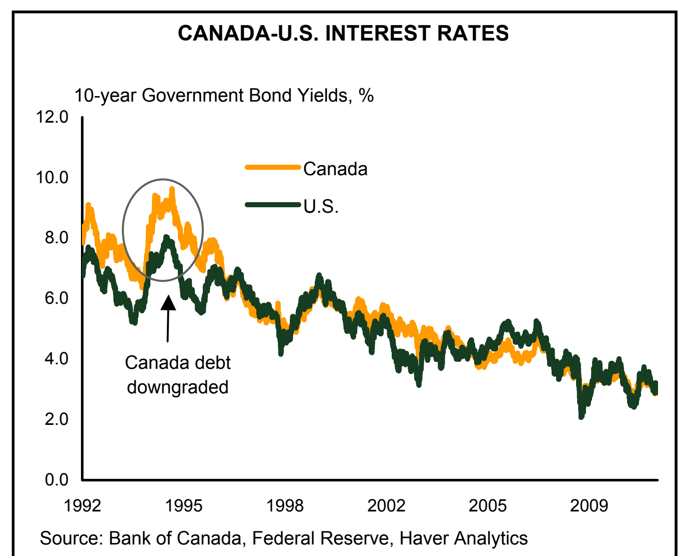
In our second scenario, in which the debt ceiling is raised in time to avoid the government having to prioritize spending, the impact will largely be limited to financial markets. If U.S. sovereign debt is downgraded by only one of the rating agencies, the financial market reaction will likely be fairly modest. Investors may maintain a preference for some of the "safe-haven" currencies that have been in play over the last several weeks – Canadian dollar, Swiss Franc, Australian dollar. Thus, the loonie may be slow to unwind recent gains. The higher valued Canadian dollar would present a modest challenge for Canadian economic growth, but likely not enough to materially impact the overall outlook.

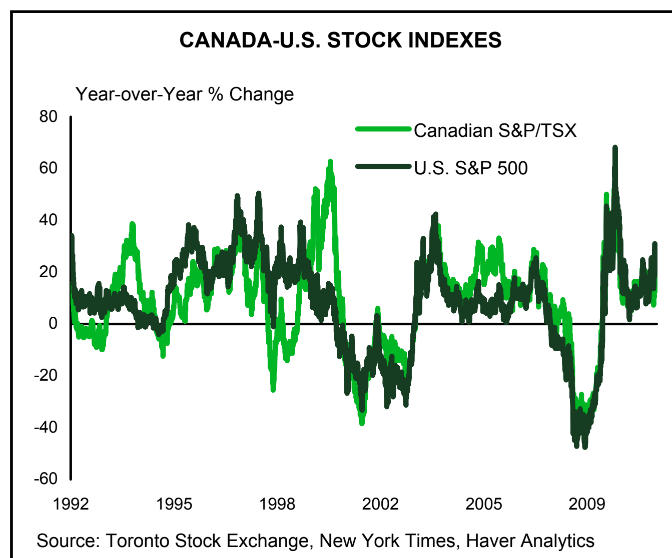
Scenario 3 - Deadline breached, payments prioritized and U.S. debt downgraded

In the event that Congress fails to raise the U.S. debt ceiling by the Treasury deadline of August 2nd, the government will have to cut spending to make up for the revenue shortfall. A subsequent downgrade to the AAA status would ultimately cause U.S. bond yields to rise and the greenback to be pressured down. The impact would flow through to Canada via three channels.

First, there is the trade channel, in which close to one-fifth of Canadian GDP is exported directly to the United States. Second, there is the direct financial channel, in which the cost of funds goes up for Canadian companies raising capital in the more liquid U.S. markets. Likewise, if equity markets swoon in the U.S., we would expect a similar response in Canada. Third, there is the indirect financial channel, where financial conditions in Canada tighten in response to tightening in the United States. However, it is possible that this latter impact could be more muted this time around.

Historically, yields on long-term Canadian bonds trade as a spread off U.S. bond yields. In fact, over the last two decades, 10-year U.S. and Canadian bond yields have exhibited a correlation of 0.95, implying that when U.S. interest rates rise, Canadian yields follow. Nonetheless, given Canada's AAA status, some investors may eye the country more favorably than the historical bond yield relationship would suggest. Canada's small size relative to global financial flows means that it would not take much rebalancing of global portfolio flows to have a large impact on the Canadian market. So, it's possible that we could see a paradoxical outcome with Canadian government bond yields falling, while their U.S. counterparts are rising. We are doubtful that this could be sustained for any length of time, due to the strong trade and economic linkages between the two countries. Much like the correlation between bond yields, the correlation between real GDP growth in Canada and the U.S. is 0.8. Thus, ultimately investors will maintain a skeptical eye on Canada as long as U.S. economic growth prospects are at risk. In addition, an overextended household sector in Canada can no longer be the growth offset that we saw coming out of the recession. This time around, growth will depend increasingly on exports. If the U.S. economy slows in the second half of the year under this scenario, we expect Canada would follow suit.





Source: Toronto Stock Exchange, New York Times, Haver Analytics

Scenario 4 - U.S. defaults on Treasuries

In our final scenario, the U.S. government misses a debt payment. This scenario is very unlikely and a good thing too for it would have the biggest impact on Canadian financial markets and the real economy. As Canadian businesses noticed during 2008-09, financial crises do not stop at national borders. A freeze up in credit markets that could accompany a U.S. default would be enough to put significant strain on credit in the Canadian economy as well. Exports would slump once again and this time the domestic economy would likely be less resilient given the highly leveraged state of Canadian households. In other words, Canada could be thrown back into an economic recession.

Bottom Line.

Depending on the outcome of the U.S. debt ceiling debate, the impact on Canada could range from a hiccup in our base-case economic outlook, to one in which we are thrown back into a recession that could have a global reach. Over the medium-term, U.S. debt sustainability augers for continued outperformance of the Canadian dollar and bonds relative to their U.S. counterparts. But, in the short-term, it is extremely difficult to know how financial markets will respond to a crisis centered on the safety of the global reserve currency. While we still believe that Washington is more likely than not to come together in time to avert a situation that causes the U.S. to fall back into a recession, the short term financial disruption that may result is a big wild card. If this fiscal crisis starts to spiral, Canada will likely to be taken along on the ride.

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