

Canada's Triple-C Vulnerability: Cars, Commodities & Construction

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Canada has recently been the grateful recipient of lavish global praise on the soundness of its financial system and the relative strength of its banks. Many have in turn torqued this and other fundamentals to assert that this leaves Canada relatively well-placed in this cycle, including the federal government, the IMF and the Bank of Canada. Yet amid all the well-deserved back-patting is the rather uncomfortable fact that Canada's economic indicators are now deteriorating nearly as quickly as their U.S. counterparts. For instance, employment has declined at almost the same sickening 5%+ annualized pace in both countries over the past four months. And, the employment-to-population measure is now falling at roughly the same clip, with Canada about six months behind the U.S. lead (*Chart 1*). Auto sales, housing and broader retail activity are also pulling a pale imitation of the horror show south of the border (*Chart 2*). Given Canada's obvious strengths, why is it being so fully dragged along for the ride in the downturn?

The answer is that Canada has three particular vulnerabilities: one that is already walloping the economy (a heavy reliance on auto production), one that is now well into the process of hitting activity (a heavy reliance on commodities), and one that potentially poses an even greater threat in the medium term (the recent construction boom). These three factors help explain why there will be precious little separation between the Canadian and U.S. economies either during this year's deep downturn or next year's shallow recovery.

Canada's relatively high dependence on autos has been well-documented (see the November 21 Focus feature "Canada's Car Economy"). Prior to last year's plunge in North American sales, Canadian production of autos and parts accounted for just over 2% of GDP, or roughly double the U.S. share. The precipitous drop in U.S. sales has thus been an even bigger negative for Canada than for the U.S. economy, with output sliding hand-in-hand in both

CHART 1
FOLLOW THE LEADER
(employment as % of population)

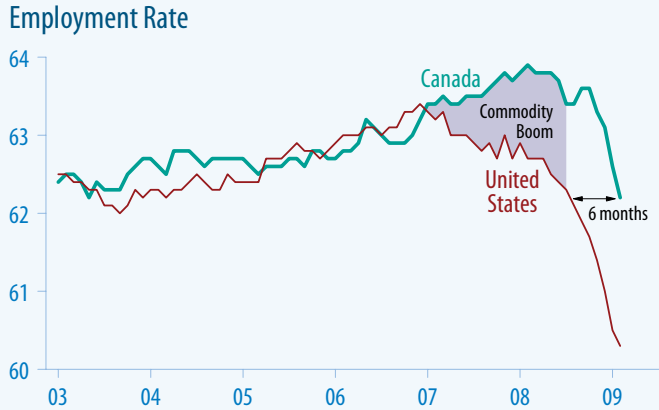


CHART 2
SPOT THE DIFFERENCE
Retail Sales (y/y % chng)

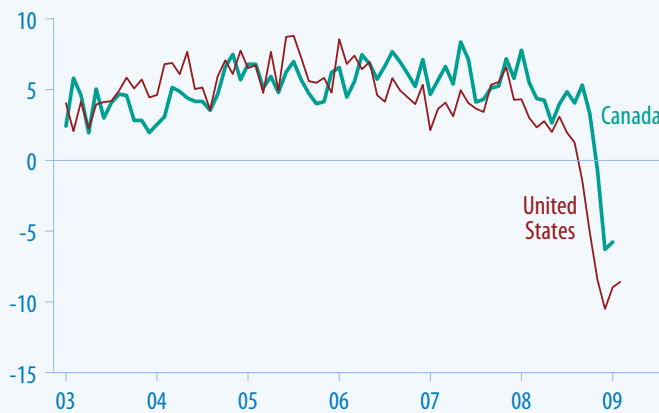


CHART 3
LOW GEAR: AUTO SHARE OF EXPORTS SHRINKS
Canada

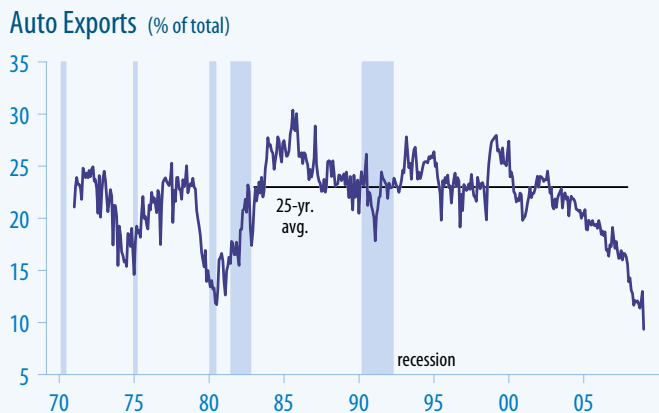
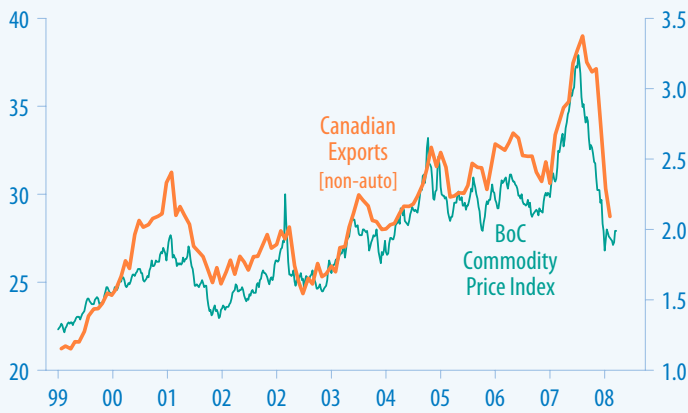


CHART 4
COMMODITY COLLAPSE HAMMERS EXPORTS



Exports = (C\$ blns : lhs) BoC Commodity Price Index (C\$-terms : rhs)

CHART 5
HAMMER TO FALL... IN THE WEST

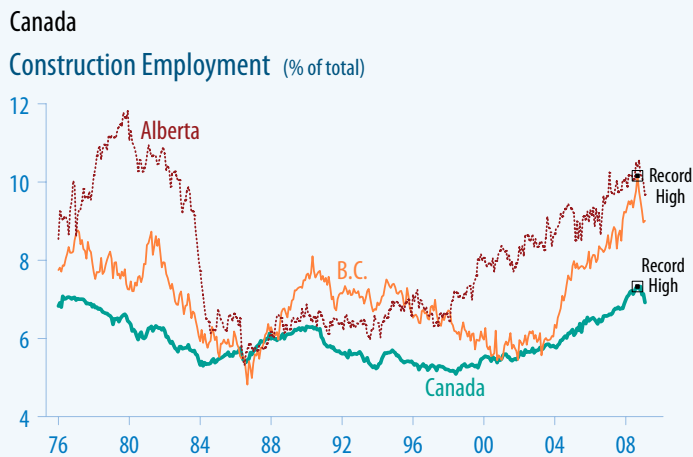


TABLE 1
WHO'S HURTING?

Employment – Canada (% chng : September 2008 to February 2009)

WORST		"BEST"	
Ontario	-2.6	Saskatchewan	+0.6
P.E.I.	-2.6	Manitoba	+0.1
B.C.	-2.3	Nova Scotia	0.0
Canada	-1.7	New Brunswick	-0.5
Quebec	-1.2	Newfoundland & Labrador	-0.8
Alberta	-1.0		

countries. As of December, the auto share of the Canadian economy had tumbled to just 1.2% of GDP, with a deeper dive on tap for January. Note that the auto share of total merchandise exports plummeted to a record low of just 9.2% in January, down from an average 23% share in the prior quarter century (Chart 3).

Canada's outsized dependence on commodities is the economy's other major Achilles heel in this environment. Most measures of commodity prices have been carved in half from their mid-2008 peaks, reversing almost four years of gains. Even in Canadian dollar terms, prices are down more than 25% from the first half of last year and back to levels prevailing in 2004. Not surprisingly, this has delivered a second heavy hit to Canadian exports, with non-auto shipments in January already down almost 20% from last year's average (Chart 4).

The stall in these two major economic engines is weighing heavily on the rest of the Canadian economy, with services and spin-off sectors now declining. Construction is one sector that is particularly vulnerable to a major correction after a long period of boom, especially on the residential side. After doggedly holding above 200,000 units right up until October (the same month overall employment peaked), housing starts have since plunged more than 35% to just 134,600 units. The impact on overall construction jobs is only just beginning to be felt, with the industry shedding 86,000 positions in the past three months alone (a 6.8% drop). After reaching a record high 7.3% of total employment late last year, the share has eased to 6.9%, but that's still miles above the 5.8% long-run average share, let alone the lows hit in the wake of prior downturns. Notably, the commodity-driven economies of Alberta and British Columbia saw the construction share of total employment peak at more than 10% late last year, and face a big comedown amid the abrupt end of building booms in both the housing and non-residential sectors (Chart 5).

More generally, Canada's specific vulnerabilities also leave some regions much more exposed to a serious reversal than others. While no region will be left unscathed by the deep global downturn, a very clear rank-ordering of those most vulnerable is rapidly emerging (Table 1). Since the

CHART 6
ONTARIO CLOBBERED

(ppt chng : September 2008 to February 2009)

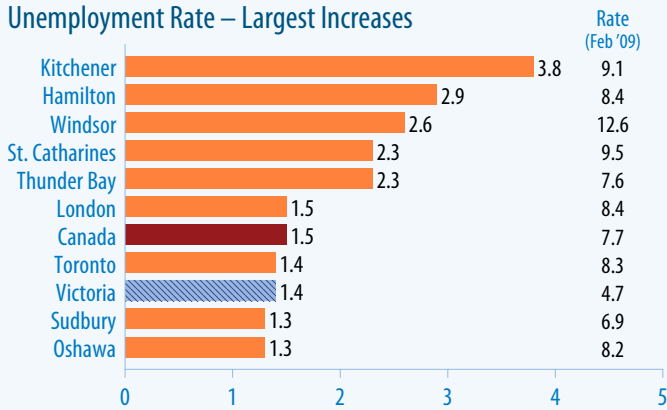
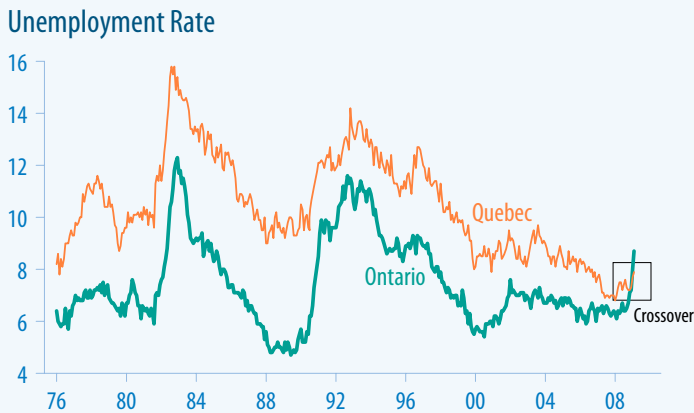


CHART 7
SEA CHANGE IN CENTRAL CANADA

Canada (percent)



global credit crisis broke wide open last September, the two hardest hit major provinces have been Ontario (autos) and British Columbia (commodities and building boom). While Alberta has so far suffered a bit less than average on the jobs front, a sharp drop in February employment hints at much more serious damage ahead from the deep cuts in capital spending plans in the province. On the flip side, Saskatchewan and Manitoba have actually managed to continue adding jobs in recent months, while some of the Atlantic provinces have only taken mild nicks.

To this point in the cycle, however, no province is yet in the same league as the hit delivered to Ontario's economy. Among the 25 largest metropolitan areas of the country, Ontario accounts for 9 of the top 10 increases in jobless rates since September (*Chart 6*). All the cities in Southwestern Ontario have seen unemployment rates post above-average increases to above-average levels. This reflects the deep impact of the collapse in auto output, but also the region's tight ties to the U.S. market more generally. The province has lost almost a quarter of its manufacturing jobs in little more than four years and 12% just since the summer of 2007. And, Ontario's jobless rate is now decisively above Quebec's for the first time in more than 30 years of records (*Chart 7*). Canada's pristine fundamentals did little to protect this region from the deep U.S. recession, and they unfortunately can do only so much to protect the vast regions dependent on commodity-based industries from the wider global downturn.

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