Does a Surplus of Current Account Deficits Lie Ahead?

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Canada's current account deficit hit a record $44.8 billion annualized in Q2, or 3.0% of GDP (*Chart 1*). Although this share is not far from the norm during the last half of the past century, the economy had emitted a near-decade long stream of surpluses up until the end of last year. Furthermore, the latest current account balance was dragged deeper into the red by the first merchandise trade deficit in more than 33 years (at $6.9 billion annualized) and to a level even worse than the latest U.S. current account deficit (at 2.9% of GDP).

The current account measures the balance of trade not only in goods, but also in services, investment income and transfers. Canada runs a hefty but relatively steady deficit in the latter three components (a combined $38.0 billion annualized in Q2), which is why the merchandise trade balance is so critical. Importantly, a current account deficit also mirrors how much net foreign investment is required to finance the aggregate deficit racked up by consumers, businesses and governments. It highlights how dependent an economy is on foreign capital inflows. A persistently large current account deficit could pose an increasing risk to Canada's financial markets, apart from paring its net international investment position (NIIP). The latter measures the value of Canadians' investments abroad and what foreigners owe us, less foreign investment in Canada and what we owe them, which is an aspect of Canada's credit worthiness.

In the 1992-94 period, Canada lost its AAA credit ratings, as persistent large current account deficits mirrored persistently large government deficits, deepening the historically negative NIIP (negative because of the foreign capital required to develop a natural resource-heavy economy). Canada was traditionally a net "debtor" nation, but it rose to a record 44% of GDP in 1994 (*Chart 2*). All AAA ratings were restored in 2002 and, after nearly a decade of current account surpluses, in 2008, Canada registered its first positive NIIP since records began in 1926. However, Canada's new net "creditor" status was short-lived, with the return of current account shortfalls moving the NIIP back into the red.

The decade-long run of current account surpluses reflected strong commodity prices and U.S. domestic

CHART 1

RED AGAIN

Canada (% of GDP)

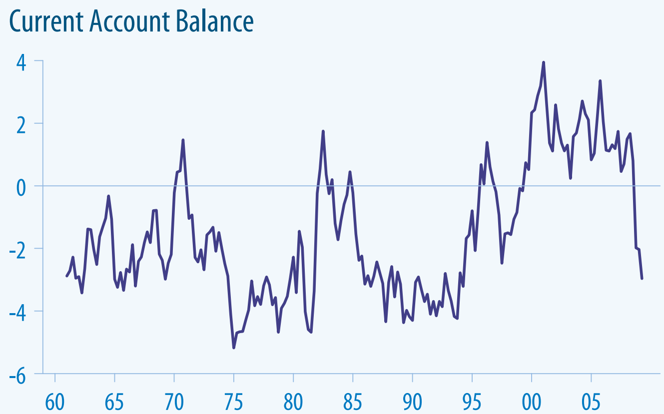
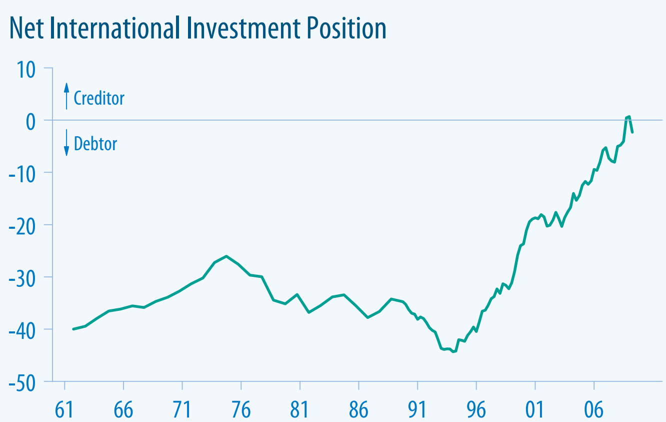


CHART 2

CREDITOR NATION... SHORT LIVED

Canada (% of GDP)



demand. High and rising commodity prices pumped the merchandise trade balance and padding business and government coffers (the former eased the reliance on external financing while the latter magnified fiscal discipline). Meantime, the U.S. economy was on a debt-fuelled spending spree, sucking in, for example, all the automobiles and housing lumber Canada could make. The onset of U.S. recession and the drop in commodity prices pushed the current account back into deficit, but the big question is whether recovery on both fronts can push the balance back into the black. This will require the merchandise trade surplus to average at least around $3.2 billion per month, which is a tall order given that it averaged a $0.9 billion deficit in the past three months (thus, a $4.1 billion swing).

Energy is the key swing factor in Canada's trade balance (*Chart 3*). Consistently rising oil prices over the past decade and steadily increasing oil sands production have pushed crude oil's share of total exports above 10%, higher than any other product. Production volumes from the oil sands are scheduled to continue increasing and prices are expected to remain strong. While crude oil gets much of the attention, natural gas has been a key contributor to the surplus over the past decade, as its average price over the past five years is more than double the average in the five years to 2000. The recent slump in natural gas prices, along with significant new supply discoveries, should limit the value of Canadian natural gas exports, although prices are likely to recover somewhat. In total, the energy trade surplus is currently averaging $3.3 billion per month, and the value would have to top last summer's record ($7.3 billion average) to alone ensure a return of current account surpluses, which is unlikely over the next year or so.

CHART 3
ENERGIZING EXPORTS

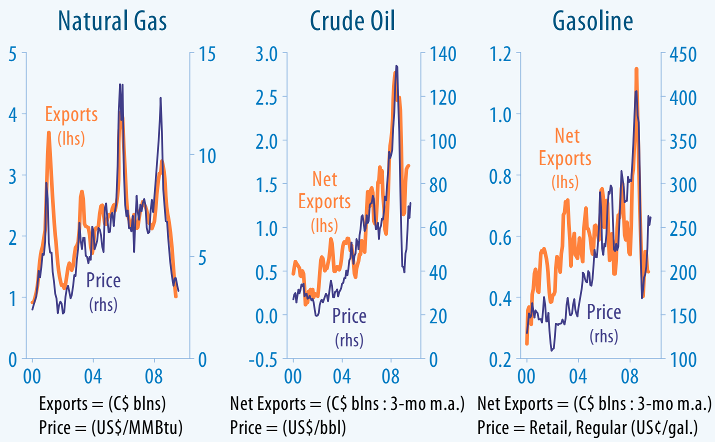
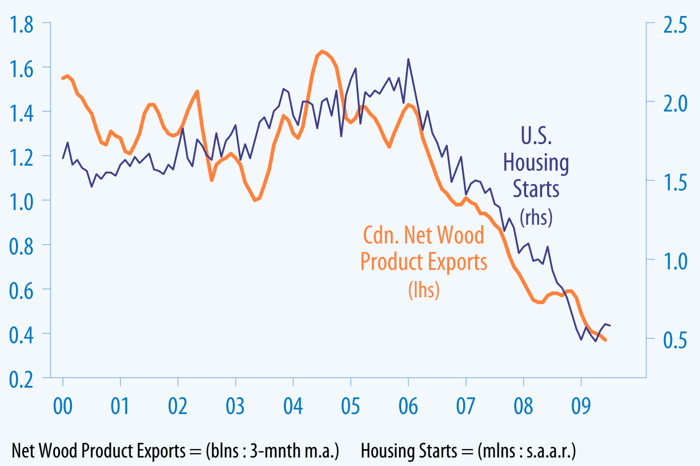


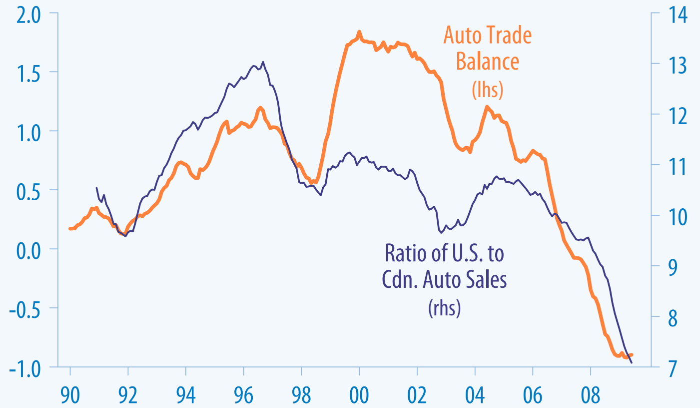
CHART 4
LIMP LUMBER



Trade in lumber and related wood products, historically a significant part of Canadian exports, has taken a backseat to energy goods. The U.S. housing meltdown was the key factor behind the two-thirds decline in wood product exports since the start of 2006 (*Chart 4*). As the U.S. housing market slowly improves, wood exports should rise, which will benefit the trade balance, but they are unlikely to have the sizeable impact on trade they once did.

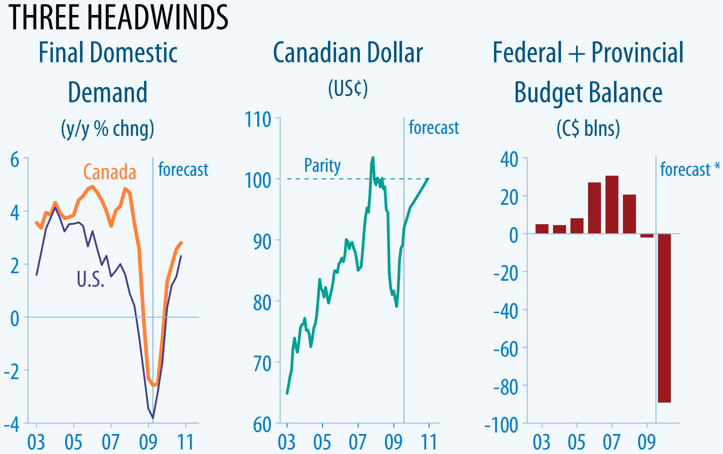
Automotive trade hit its high point for Canada at the turn of the millennium when the legacy of a weak Canadian dollar combined with surging U.S. auto sales to produce a record auto-related surplus *(Chart 5)*. Since then, auto exports have trended consistently lower, before falling off a cliff during the recent crisis. Imports, meantime, held relatively steady until also plunging early this year. The differing performance was due to growth in Canadian auto demand outpacing the

CHART 5
DRIVING DOWN



Auto Trade Balance = (blns : 12-mnth m.a.) Ratio of U.S. to Cdn. Auto Sales = (12-mnth m.a.)

CHART 6
THREE HEADWINDS



* various budgets

U.S., with that trend accelerating over the past three years and pushing the autos balance into a multi-period deficit for the first time since the late 1980s. This emphasizes that it's not only the vigour of U.S. domestic demand that drives Canada's overall trade balance (via exports) but also the robustness of Canadian domestic demand (via imports). We expect Canadian private spending growth will remain stronger than in the U.S., so the autos deficit is likely to remain a fixture on the trade landscape.

The relative outperformance of Canadian domestic demand will act as a headwind on the current account. Another headwind will come from the erosion of export competitiveness caused by a strengthening Canadian dollar (we judge that the loonie is destined to hit parity again before the end of next year). Paradoxically, while stronger commodity prices help trade performance, they also hinder it by their positive impact on the currency; these forces tend to neatly counteract each other. A final headwind could come from stubbornly large government deficits amid the expected pick-up in private spending (*Chart 6*).

Bottom line: Canada's merchandise trade balance could remain in deficit into 2010, but should shift eventually back to surplus as the global economy accelerates. However, it's unlikely that this will be sufficient to push the current account back into the black anytime soon. Fortunately, any current account deficit that persists should be small by historical standards, posing little risk for Canadian financial markets and causing only modest deterioration in Canada's net international investment position.