

European Vacation for Canada's Recovery?

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Europe's debt tremors are beginning to rattle some windows in North America. Until very recently, financial markets had largely seen the simmering public sector debt issue as a problem for "over there", and only of peripheral concern for the Canadian outlook. That can best be captured in the divergent trend between the Canadian dollar and the euro in the past six months—prior to the emergence of Greece's debt woes, the two currencies had apparently been joined at the hip for most of the financial crisis and recovery (*Chart 1*). However, the euro has plunged 17% from its late-2009 peak, even as the Canadian dollar has chopped around in a tight range, seemingly oblivious to the mounting concerns over European public sector debt. While the loonie has taken a big step back in recent days, and equity markets have certainly shuddered, Europe's debt debacle has yet to prompt any significant changes in the consensus view on Canada's growth outlook, and/or on the timing of Bank of Canada rate hikes. Could that soon change?

The direct impact on Canada of Europe's woes is meaningful, but certainly manageable. The European Union (including the U.K.) accounted for 8.6% of Canadian exports in the past 12 months, and just under 5% excluding Britain. In comparison, all emerging markets now account for 10.8% of Canada's exports (*Chart 2*). Thus, it would take a two percentage point drop in Eurozone GDP, a heavy hit indeed, to shave even 0.1 percentage points from Canadian GDP. However, as we so painfully learned in the Asian crisis of 1997/98—and this episode has as many parallels with the Asian crisis as it does with the 2007/08 financial crisis—Canada can be affected much more by the indirect channels than the direct trade linkages. In this case, the tremors will land on Canada's doorstep largely through financial markets and commodity prices.

As vividly illustrated in the past month, the spillover from Europe can seep into Canada through softer equity markets, wider credit spreads, and even higher interbank lending costs (*Chart 3*). The widening gap between Libor and Overnight Indexed Swaps (OIS) since late April is a key

CHART 1
CANADA AND EUROPE: SEPARATE WAYS
(US\$ per currency unit : as of May 20, 2010)

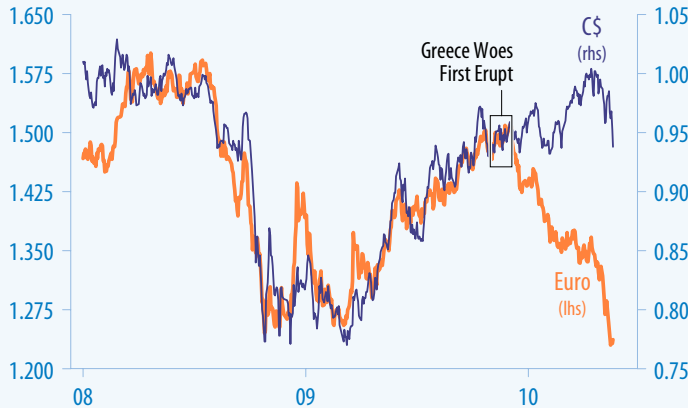


CHART 2
CANADIAN EXPORTS: WHERE NOW?
Canadian Merchandise Exports (% of total)

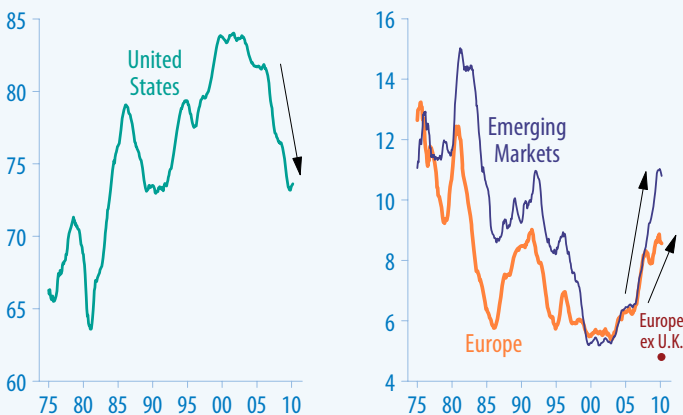


CHART 3
UNWELCOME ECHO
U.S. Libor – OIS Spread (3-mnth : bps)



CHART 4
LOONIE AND COMMODITIES: THE TIES THAT BIND

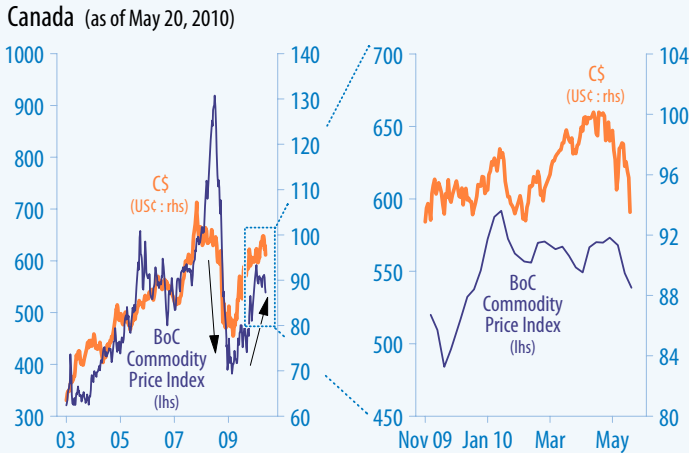
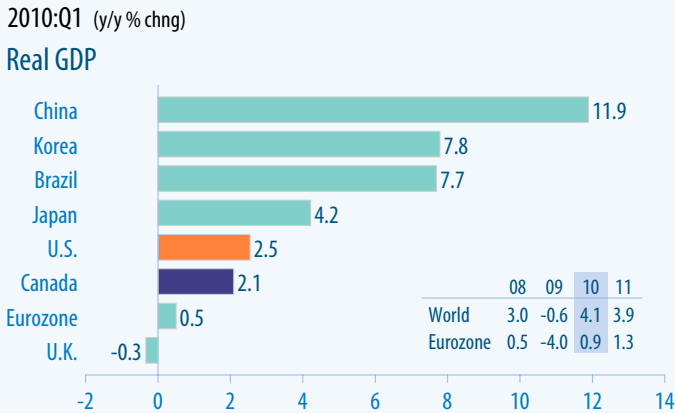
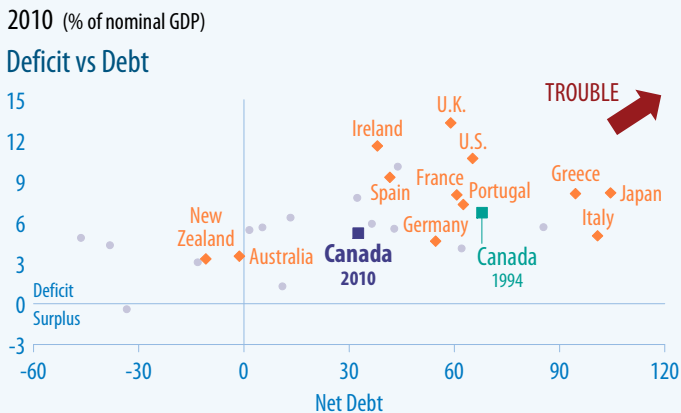


CHART 5
GLOBAL GDP: WORLD OF DIFFERENCE



Brazil, Canada = estimate

CHART 6
OECD FISCAL LANDSCAPE



Dots represent countries in the OECD, except Norway, which has huge assets

measure of building stress in money markets, and a signal of renewed concerns over global banks. While this spread remains a fraction of that seen in late 2007 (let alone the spike in late 2008)—it has risen 17 bps in three weeks—the sudden widening is an unfortunate echo of the 2007 credit crunch, when it jumped 50 bps in the opening days. The combination of higher bank funding costs, wider credit spreads and sagging stocks could hit business and consumer confidence, hammer global growth, and sideswipe commodity prices, all of which could take a big bite out of Canadian growth prospects.

Commodity prices have already been somewhat staggered by mounting concerns over the European growth outlook, with the CRB falling more than 14% from its highs earlier this year. Europe is not the only issue gnawing at commodities, with the steady tightening of financial conditions in China, and the view that growth in that country may have already peaked. Commodity prices are now barely above year-ago levels (i.e. when the North American economy was still in recession), and it's no coincidence that they have weakened since Greece's fiscal woes first fully came to light late last year. Notably, the Canadian dollar has yet to fully respond to this pullback in commodities (Chart 4), supported by its status as a relative safe harbour and the prospect of independent Bank of Canada rate hikes. If commodity prices continue to break lower, the previous near-unanimous view that the loonie is poised to power through par would come under intense question.

But before aggressively marking down the loonie's prospects, it's worth reconsidering just how serious a blow the global growth outlook has sustained by recent events. Even before the new round of fiscal austerity measures, Europe wasn't expected to contribute much to global growth. The recovery is being driven largely by emerging markets, Asia in particular (Chart 5). Elsewhere, Latin America is being powered by Brazil which grew at an 8.4% annualized rate in Q4. In any case, from 2004 to 2007 when global growth averaged almost 5%, the Euro Area only contributed a meagre 0.4 ppts per year. In addition, the near-term impact of fiscal tightening is likely being overstated. We estimate that European fiscal policy will actually make a slight positive contribution to growth in 2010 (as net stimulus in Germany outweighs deep cuts in the smaller economies), with the drag coming in 2011, but even then a manageable 1% of Eurozone GDP.

CHART 7

RATE HIKE EXPECTATIONS: YO-YO

Canada (implied yield : 100 minus price : as of May 20, 2010)

3-Month Bankers Acceptance Futures – June 2010 Contract

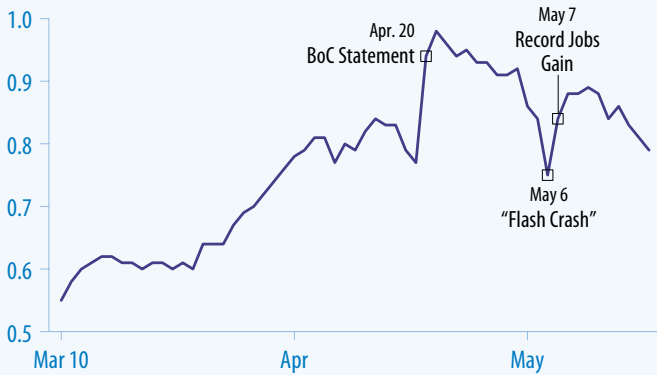
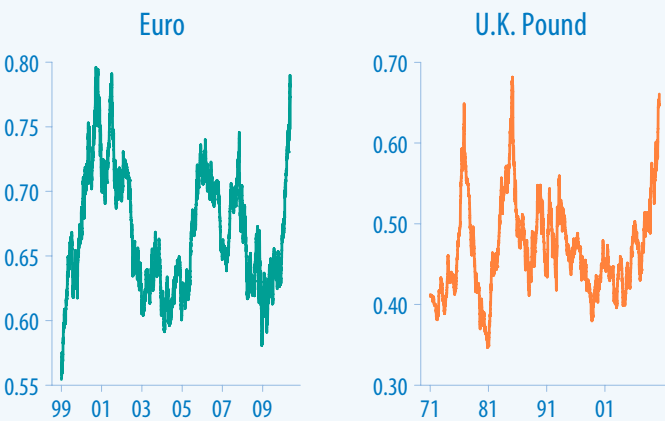


CHART 8

CANADIAN DOLLAR: NEAR THE HIGHS

(currency unit per C\$: as of May 20, 2010)



While Europe’s fiscal belt-tightening may not impose a significant headwind on the global economy, it will make an impact domestically. Efforts to narrow budget deficits are long-term projects, and will require years of sustained restraint. To put it in perspective, many of the deficits and debts in Europe relative to GDP are larger than Canada’s in the mid-1990s, when the fiscal situation here was at its worst (*Chart 6*). Without a sharp pickup in the private-sector economy, Europe faces many years of slow growth and economic hardship.

From a near-term standpoint, the Bank of Canada will need to decide by the June 1 policy meeting if the European tremors have significantly altered the domestic growth and inflation landscape. Reuters’ surveys in early May and again today found all 12 of Canada’s primary dealers calling for a rate hike in June (as well as in the next two meetings), apparently unfazed by the recent market volatility. However, financial market pricing is much less certain, with a June rate hike now seen as nearly a 50-50 probability. The market has see-sawed wildly in the past month on the outlook for the June 1 decision, with at least three U-turns in view over that stretch (*Chart 7*). We continue to lean to the view that the Bank will indeed begin hiking rates at the start of June amid the powerful rebound in employment and housing, and the Bank’s discomfort with rates stuck at emergency lows. However, the debate is by no means completely settled, with the Fed still in an extended holding pattern, commodities plunging, and the very real possibility that European tremors could rumble even louder.

Bottom Line: The European debt debacle poses serious risks to Canada’s economic outlook, primarily through financial market and commodity price channels, not through its direct impact on trade. We have already nudged lower our view on the Canadian dollar, and the downside risks for the currency are now much more prominent than a few short weeks ago. To this point, we have only shaved our 2011 growth forecast for Canada, although we are honing our axe for the first time in more than a year (i.e. GDP forecast revisions have been entirely to the upside since bottoming out in the spring of 2009). Similarly, we have yet to alter our call on the Bank of Canada, but a steady stream of rate hikes at each and every decision date over the next year looks much less probable. We would conclude by suggesting that while the economy and the Bank of Canada may not take a European vacation, many Canadians likely will as the Canadian dollar is now pressing up against record highs against the euro and Sterling (*Chart 8*).

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