Euler Hermes Economic Research

Country Report

Canada

Resilient fundamentals to be hampered by falling oil prices

General Information

GDP	USD1,830 bn (World ranking 11, World Bank 2013)
Population	35.2 mn (World ranking 37, World Bank 2013)
Form of state	Federal Parliamentary (Constitutional Monarchy)
Head of government	Steven HARPER (CON)
Next elections	2015 federal, legislative, provincial

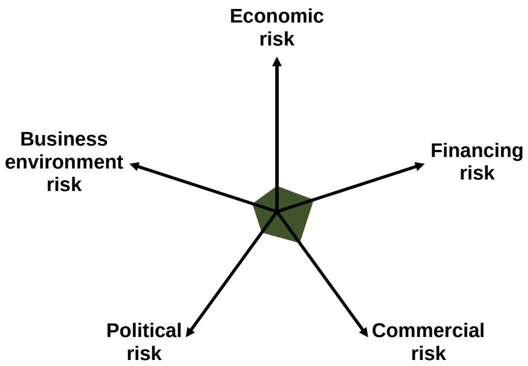
Strengths

- Politically stable
- High per capita GDP
- Strong banking system
- Conservative monetary policy
- Modest fiscal deficits
- High data transparency
- Strong manufacturing
- Large oil and gas reserves
- Diverse GDP

Weaknesses

- Sensitive to commodity prices
- Dependence on exports, particularly to the U.S.
- High exposure to the U.S. economy
- High personal debt
- Elevated housing prices
- Government revenues dependent on natural resource production
- Deflationary pressures

Country Rating AA1



Source: Euler Hermes

Trade structure

By destination/origin (% of total)

Exports		Rank		Imports
United States	74%	1	50%	United States
China	4%	2	11%	China
United Kingdom	4%	3	5%	Mexico
Japan	3%	4	4%	Japan
Mexico	1%	5	4%	Germany

By product (% of total)

Exports		Rank		Imports
Crude Oil	17%	1	7%	Cars And Cycles
Cars And Cycles	11%	2	6%	Crude Oil
Refined Petroleum Products	5%	3	4%	Engines
Non-Monetary Gold	4%	4	4%	Vehicles Components
Non Ferrous Metals	4%	5	4%	Commercial Vehicles

Source: Chelem (2012)

Economic Overview

Resilient fundamentals

Since the end of the recession, the Canadian economy has been more resilient than most other developed economies, including that of its largest trading partner, the U.S. Over that period, Canadian GDP has grown at a healthy annualized rate of +2.7%, compared to the long term average of +2.4%, and compared the U.S.'s +2.5%. Insolvencies have been steadily falling since the mid-2000s and are expected to fall another -1% in 2015. Only 2 of 17 sectors are unfavourable, paper and textiles, both of which are struggling throughout the developed world. While the economy is relatively diverse, exports account for 30% of GDP, and 74% of those exports go to the U.S. Thus around 22% of the Canadian economy is exposed to the health of the U.S. economy, and 8% is exposed to the rest of the global economy which is currently anemic.

Key economic forecasts

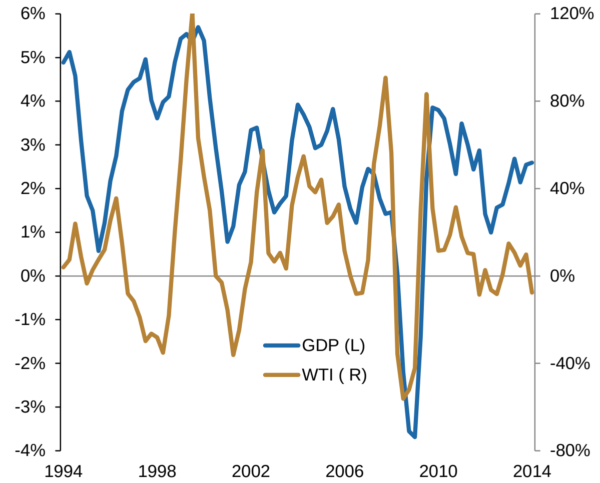
	2013	2014	2015f	2016f
GDP growth (% change)	2.0	2.5	2.0	2.1
Inflation (% end-year)	1.2	1.8	0.9	2.5
Fiscal balance (% of GDP)	-3.0	-2.5	-2.0	-1.5
Public balance (% of GDP)	89.1	87.4	90.0	91.1
Current account (% of GDP)	-3.0	-2.2	-2.9	-2.6
External debt (% of GDP)	70.8	72.0	72.8	73.7

Sources: IHS, national sources, Euler Hermes

Falling oil prices a headwind

The recent drop in oil prices is imposing a significant drag on the economy. While the energy sector accounts for only 10% of Canadian GDP, the economy is sensitive to changes in the prices of oil (and other natural resources such as minerals and timber). The chart shows the high correlation between the price of West Texas Intermediate (WTI) crude oil and GDP. However, the relationship has myriad positive and negative effects. On the positive side, lower gasoline prices are benefitting the Canadian consumer, adding as much of +0.8% to GDP. Oil prices have also driven down the value of the Canadian dollar (CAD) sharply, attracting U.S. tourists who will add to consumption, while making non-petroleum exports more competitive. The negatives are a bit stronger however, including a sharp drop in petroleum exports, and effects localized to the oil patch including a steep fall in capital spending, increased unemployment, a fall in housing values, and deteriorating provincial finances that rely on oil revenues. On net, EH expects that the drop in oil prices will exert a drag of -0.4% to -0.6% on 2015 GDP, bringing the forecast back below trend to +2.0%. Oil prices normally have a lagged effect on the economy, so EH expects to see a continued drag from prices which started to collapse last summer.

Real GDP growth vs. Price of West Texas Intermediate (WTI), y/y

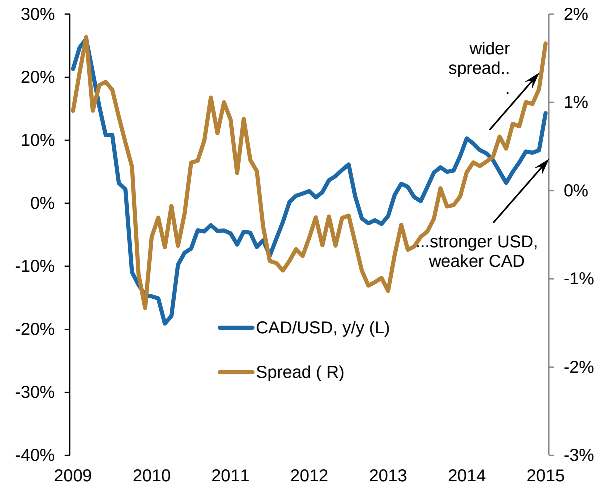


Sources: IHS, CANSIM, EIA, Euler Hermes

Lowering rates, weaking CAD

The Bank of Canada (BoC) reacted to the drop in oil prices with a surprise rate cut in January, lowering the overnight rate from 1% to 0.75%, the first move since an increase in September 2010. The BoC justified the move as an insurance policy on two fronts as a result of the fall in oil prices: first to counter any threat to GDP growth, and second to counter any deflationary pressures. In fact headline consumer inflation fell to +1.0% in January, the bottom of the BoC's target range. The move towards monetary policy accommodation comes at a time when it is widely expected that the U.S. Fed will start raising interest rates in mid-2015. As such, the spread between real U.S. and Canadian 10 year interest rates has gone from +0.5% to +1.5% since July 2014, and it is expected that this spread will continue to widen. As shown in the chart, relatively higher U.S. interest rates have boosted the value of the USD against the CAD by +14% since July 2014. In this case, the weaker CAD will have the beneficial effects of increasing export competitiveness, helping close the trade gap, and importing inflationary pressures.

The Value of the Canadian Dollar (CAD) vs. Interest Rate Spread



Sources: IHS, CANSIM, Federal Reserve, BLS, Euler Hermes

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