OBSERVATION

TD Economics

May 23, 2012

WHAT A GREEK EXIT WOULD MEAN FOR THE CANADIAN ECONOMY

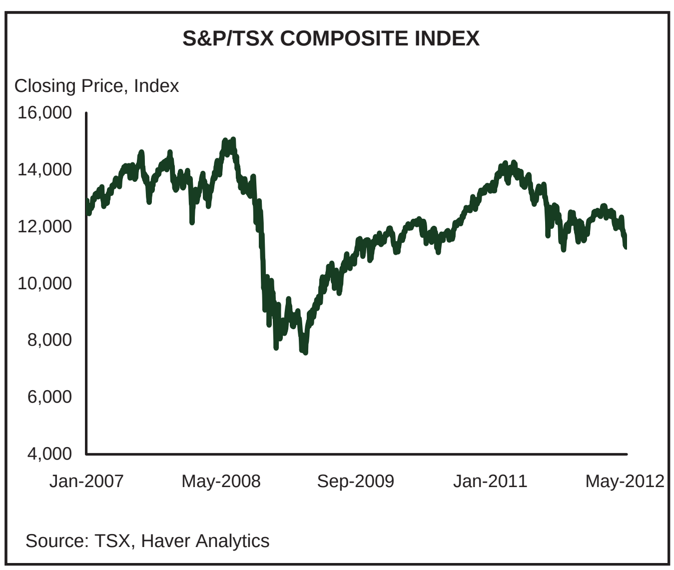
Highlights

- Our most recent Canadian QEF builds in mild recession in Europe and continued financial market volatility due to European sovereign debt concerns. However, in recent weeks, risks of a disorderly Greek exit from the Euro zone have increased. In this report, we highlight what the worst case scenario would look like for the Canadian economy.
- Canada has little direct exposure to Europe and the real economy would be hit more significantly through indirect channels. The event would lead to financial market turmoil and commodity prices would tumble.
- High household debt and an overvaluation in the existing home market leave the economy more vulnerable to a negative external shock than it has been in the past.
- In a worse case scenario, where there is a systemic crisis in Europe, Canada's economy would endure a severe recession, with the decline being substantially worse than that experienced during the 2008/2009 recession.

Over the last several weeks we have been overwhelmed with questions about how a potential Greek exit from the euro would impact global financial and economic markets. In two accompanying papers, we answer some of the main questions with respect to how a Greek exit could occur and what it might mean for Europe and the United States. In this piece we explore the financial and economic impacts on the Canadian economy.

Downside Risks to the Canadian economic outlook have intensified

Up until now, Europe's financial and economic struggles have had relatively little negative impact on Canada's economy. Canada's direct trade exposure to Europe remains small, at only 10% of total merchandise exports. Direct financial exposure, including claims of Canadian banks on European assets, are also a relatively slim share of total bank assets. This country's exposure has been somewhat larger through indirect channels, including the impact of European weakness on the United States, China and on world commodity markets. Canada has also been affected through increased currency and equity market volatility. As things currently stand, TD Economics has not changed its base case outlook for modest economic growth in Canada in 2012 and 2013. At the time of our last forecast, the assumption was that the European fiscal crisis would be a protracted and messy



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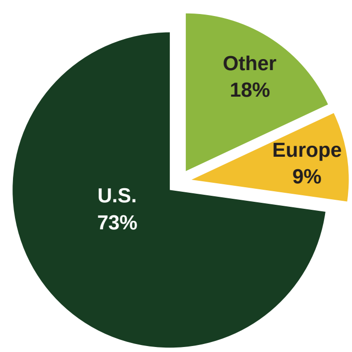


Source: Statistics Canada/Haver Analytics

affair, so it was built into the outlook.

However, the risks in Europe have intensified in recent weeks. There has been a shift in political sentiment in Europe towards greater resistance over austerity. Most importantly, an election in Greece failed to produce a winning coalition, which means a return to the polls on June 17th. There is also a risk that a run on Greek banks could force an exit of Greece from the euro, but this will not occur if Greece continues to receive considerable financial support from the rest of Europe. So, a Greece exit over the next few months is still not the most likely outcome. However, the risk has gone from a very remote possibility to one that cannot be ruled out as a real possibility.

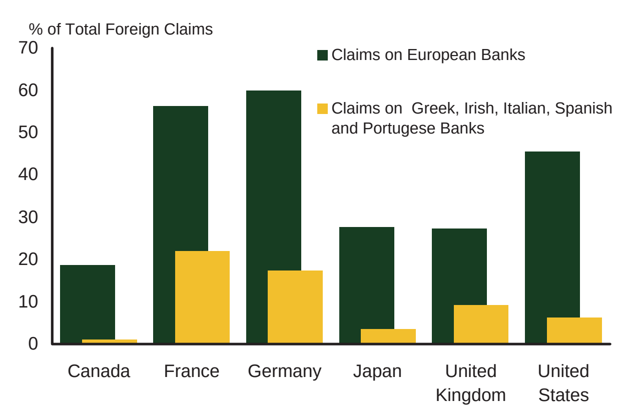
If Greece does adopt a new currency, it will be a major financial shock. Financial markets will immediately start to speculate that other countries will follow suit. Ireland, Portugal and Spain will come under the most financial distress. The question then is whether European leaders can take policy actions to stem the contagion. There are options that would help to ring-fence Greece. If such an outcome occurs, financial market volatility will subside, but there would still be a toll on the global economy. As such, the Canadian economic forecast would likely need to be scaled back to reflect weaker exports and the fallout on consumer and business confidence from the financial instability, but the changes would be modest.

The true concern, from a Canadian perspective, is if Greece leaves the euro and the contagion pressures are not contained. More specifically, such an outcome would be an enormous blow to the European banking system, which would have global ramifications. Let's run through how Canada would be affected.

Financial Implications

A systemic global banking crisis would weigh heavily on Canadian financial markets. Canadian government bonds, would be an exception, as they would likely rally as investors flee from risk. But while Canadian government bond yields would likely sink to new lows, they would still underperform U.S. Treasuries. As investors around the world pile into U.S. dollar-denominated investments, the loonie would weaken substantially against the U.S. dollar. And with commodity prices likely falling amid concerns over a weakening global economy world equity markets would tumble. With Canada's heavy focus on commodities, the S&P/TSX would likely be hit particularly hard in the aftermath of a disorderly Greek exit from the eurozone.

On the plus side, the Canadian banking system would enter the crisis from a position of relative strength. Canadian banks have little exposure to Greek and other vulnerable European economies. For instance, Canadian bank holdings of debt from Greece, Ireland, Italy, Spain and Portugal account for roughly 9% of Tier one capital, compared to 20% in the United States[1]. In addition, Canadian banks have appeared to reduce their relatively limited direct exposure to Europe in recent months. Accordingly, Canada's banks appear to be relatively well positioned to withstand the market fallout. That said, concerns about counterparty risk would likely disrupt the interbank funding markets and, thus, raise bank funding costs. This development would almost certainly provoke a response from the Bank of Canada, which would do everything in its power to ensure adequate liquidity. The Central Bank would probably cut the overnight rate to its lower bound of 0.25%. And, if the economic outlook con-

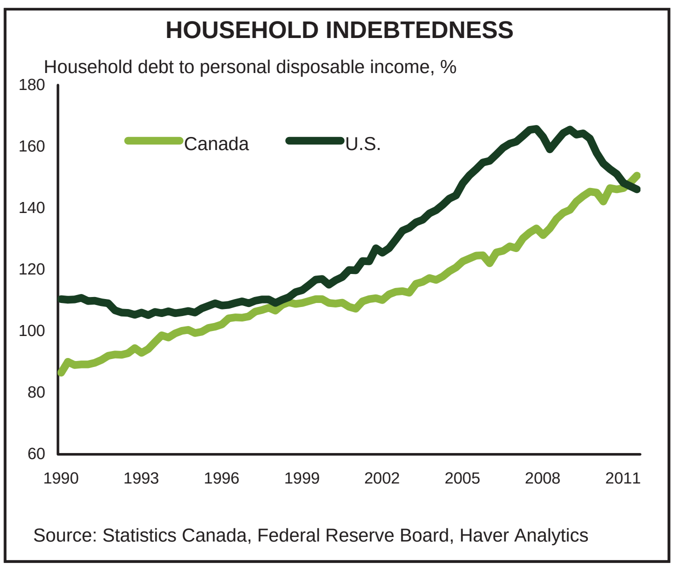


Source: Bank for International Settlements tinues to sour, the Bank of Canada would probably consider non-conventional monetary policies (i.e., quantitative easing) to provide support to the economy.

The real economic Impact

Much like the United States and other advanced economies, a severe systemic financial crisis due to contagion in Europe would, with a short lag, start to hit Canadian real GDP and employment hard through substantially lower resource and non-resource exports, reduced domestic wealth and confidence. It is worth noting that a sharp depreciation in the Canadian dollar would act as a shock absorber for Canada's economy, as it would lessen the blow of falling U.S.-dollar commodity prices in own-currency terms and raise Canadian manufacturing export competitiveness. Nonetheless, Canada's export sector would experience another severe setback.

What separates Canada from other major advanced economies, however, is its high and rising vulnerability to domestic financial excesses that have formed in recent years.



While corporate balance sheets remain strong, household debt has become excessive and the housing market is in our view 10-15% overvalued, leaving households more vulnerable to a negative economic event. A global financial crisis could be a major catalyst for a sharp housing market correction and household deleveraging – albeit to a lesser extent than was evident in the U.S. during the past recession. Moreover, Canadian governments would have less room to stimulate compared to the first crisis in 2008-2009. While Canada's economy would probably still fare better than most in the eurozone under this scenario, it would likely underperform that of the United States. In a worse case scenario, the Canadian economy would likely endure a severe recession, with the decline being substantially worse than that experienced during the recent recession as both exports and domestic spending contract heavily.

Bottom Line

Our base case remains that Canada's economy records moderate growth, with the excesses in the household sector and in the domestic housing market being reduced gradually over time. And if contagion from a Greek exit is contained by policymakers in Europe, then any impact on the economy due to increased financial turbulence should prove limited and temporary. Nevertheless, a disorderly exit of Greece from the eurozone represents the number one risk to Canada's economic outlook.

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Endnotes:

1. Bank of Canada Financial System Review, December 2011. http://www.bankofcanada.ca/wp-content/uploads/2011/12/fsr_1211.pdf