TD Economics

Data Release: The U.S. Fiscal Cliff and What It Means for Canada's Economy

- All eyes were on the U.S. election yesterday, the outcome of which will shape America's economic fortunes. Given Canada's close economic ties with the U.S., the election results matter north of the border as well. The people have voted, and they chose to keep the political landscape the same as it was leading into the elections. Barack Obama will remain President and Democrats have a majority in the Senate while the Republicans dominate the House of Representatives.

- The risks that the U.S. economy will fall off the looming fiscal cliff and fall back into recession is one of the top risks facing Canada's economy as we head into 2013. The ability of Canada's economy to grow moderately and sustainably over the next two years will in no small part depend on how the still-divided U.S. Congress tackles its fiscal issues. For one, the need for Canada to continue to grow its exports to a recovering U.S. economy is becoming increasingly important in light of a fatigued consumer sector at home. Second, to the extent that the U.S. federal government can't address its fiscal uncertainties due to ongoing brinksmanship risks further waves of global financial market volatility and dampening the appetite of Canadian businesses to invest.

- In a TD report released today, "Fiscal Impacts Under New Congress Not an Open and Shut Case", we outline three possible scenarios and U.S. economic outcomes given a divided congress. One caveat that we point to is the challenge of estimating behavioural responses to changes in taxes and spending measures.

Scenario 1 - The first is political deadlock continues, and all the planned cuts are allowed to take effect in the New Year.

- The first scenario is that the U.S. economy falls off the fiscal cliff and back into recession. TD estimates that this will shave 3 percentage points off U.S. real GDP, tipping the economy back into recession. Historical relationships suggest that a 1% decline in U.S. real GDP leads to a 0.4-0.6% decline in Canadian economic output. Based on model results, driving off the U.S. fiscal cliff could shave 1.2-1.8% off Canadian real GDP in 2013, with this nation's economy only narrowly avoiding a recession.

- While this estimate provides a rule of thumb, the impact on Canada's economy will ultimately be contingent on not only the magnitude of the fiscal drag, but the mix of tax hikes and spending cuts. In general, the direct impact on Canadian exports is heavier when taxes are raised. The hit to Canadian exports to the U.S. are likely to be larger and more immediate under tax increases, while government spending cuts in the U.S. will have larger domestic than external implications. This is because Canadian trade with the U.S. is largely concentrated in consumer goods and business investment – items which will likely be hit harder by an increase in taxes. Indeed, under the current legislation, the majority of the hit is likely to come from tax increases (2.1%) and the Canadian economic hit is likely to be large. However, taking a more granular approach to estimating the overall hit to exports and then knock on effects to employment and consumer spending produces a smaller economic hit of around 1% to Canadian real GDP next year. The economy would likely still grow, but at a rate of less than 1%.

- The potential for extreme financial market volatility in this case puts some downside risk to these estimates. These estimates don't include the economic impact from heightened financial market volatility which could dampen Canadian consumer and business spending significantly.

Alternate and more likely scenarios

- It seems highly unlikely that Congress would allow the U.S. to run off the cliff. A more reasonable assumption is that a compromise is reached – perhaps in the 11th hour – that cuts this hit to real GDP growth in 2013 roughly in half – to about 1.5 percentage points. In today's report, we calculate that if a deal to address the cliff is consistent with the initiatives in the Obama campaign (i.e., a moderate tilt towards tax increases as opposed to spending cuts), then the reduction in Canadian real GDP growth would be 0.5-0.7% next year. Keep in mind that this rough impact is already factored into TD Economics 2013 baseline growth forecast of just under 2% next year. The financial implications under this scenario would likely be more favourable. Although a late deal would likely lead to financial-market jitters, the ultimate resolution would make investors confident that the economic recovery will continue and that the U.S. has begun to tackle its longer-term fiscal problems.

- Alternatively, the can could be kicked further down the road as congress continues to negotiate terms of fiscal consolidation. While the economic drag from fiscal restraint will be pushed into the future, continued uncertainty will act as a headwind to economic growth both in the U.S. and Canada. Businesses in particular would remain cautious about investing and hiring under this scenario. In any event, it is highly likely that a compromise would be reached by the end of next year.

Other issues

- With the election in the rearview mirror, a number of trade related issues important to Canada will come under scrutiny in the months ahead. Attention will quickly turn back to the fate of Keystone XLS, which is considered an important development for growth in the Canadian oil sands. TransCanada reapplied for a Presidential permit in May 2012 with revised routing through the controversial area in Nebraska. Nebraska is still assessing the new route, and once it has made a decision, the State Department will make it's determination on the Presidential permit, likely in the spring of 2013. The approval is more uncertain under President Obama than it would have been under a Romney administration, but it seems likely that if Nebraska approves the new routing the pipeline will ultimately be approved.

- Obama's re-election will support expectations that the U.S. administration will follow through on the Canada-U.S. perimeter security and trade agreement that was signed between the two countries in 2011, which is aimed at freeing up border bottlenecks and allow freer flow of goods a people across the border. In addition, voters in Michigan rejected a proposal that would have called for a state-wide referendum on a new border crossing between Canada and the United States. This removes a hurdle in the way of the proposed bridge between Windsor and Detroit, which includes full funding by the Canadian government. Almost $2 billion per day in trade currently crosses at the border at Windsor and Detroit.

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