TD Bank Financial Group

TD Economics

Special Report

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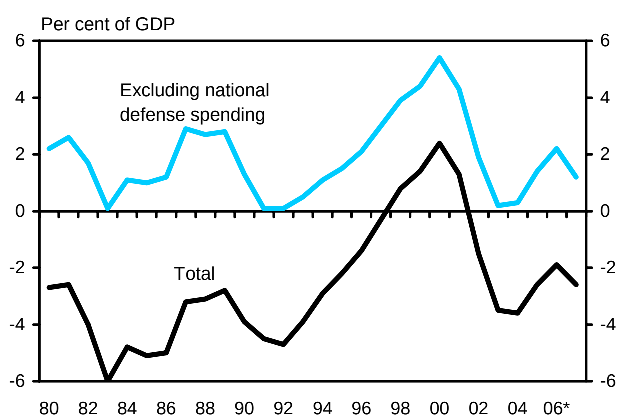
ECONOMIC IMPACT OF U.S. ELECTIONS ON CANADA

There have been questions raised as to what the economic implications of the U.S. election results are for Canada. We now know that Democrats have won the majority of seats in the U.S. House of Representatives as well as a slim one-vote lead in the 100 seat Senate. In order for legislation to be made law, it must pass both chambers of Congress and be signed by the President. Full control of the legislative branch will make it easier for the Democrats to pass legislation there, but ultimately to be enacted, these bills must be signed by the President. Any bill vetoed by the President would require a supermajority of two-thirds support in each chamber in order to override the veto, something the Democrats do not have. For this reason, any legislation which passes will require the broad support of both Democrats and Republicans. In general, we do not see the election having a material impact on the Canadian economy.

U.S. FEDERAL DEFICIT



*Congressional Budget Office (CBO) estimates for 2006-2007
Source: U.S. Department of the Treasury and CBO

HIGHLIGHTS

- **Results of U.S. election unlikely to have economic impact on Canada**
- **U.S. Presidential veto means any new legislation will require bipartisan support**

Most polling suggested U.S. voter concerns centered on American involvement in Iraq. This may accelerate the transition toward Iraqi-control on the ground, but this process was likely in the cards regardless. Should this limit the U.S. federal government's future military spending, this may improve the fiscal position of the government, but this process is likely to be quite slow and deliberate. Democrats have been in favour of formal talks with Iran and North Korea over their nuclear programs, which if successful, could lower the risk premium seen in oil markets. But, while Congress does retain control over the federal government's purse strings, ultimately, the President maintains sole command over foreign affairs.

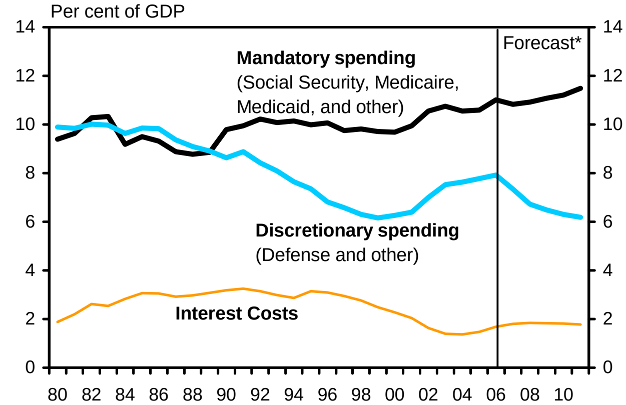
Other announced economic priorities for the Democrats have included raising the minimum wage from $5.15 to $7.25, allowing Medicare to negotiate directly with drug companies for lower prices, easing restrictions to get generic drugs on the market sooner, minor revisions to the tax code to reduce the tax burden on the middle class, maintaining agricultural supports in a bill due in 2007, repealing some subsidies to the U.S. oil industry, and expanding the use of alternative fuels. These changes represent either a continuation of the status quo or are of limited economic impact at the macro level. The Democratic Party is likely to put greater emphasis on environmental programs which could have a potential impact on Canada, but significant changes would likely meet resistance from the executive branch. With Presidential elections two years away and campaigning likely beginning for that within a year, both parties will be keen to focus on posturing for the next election.

On the trade front, the Democratic Party has historically been very critical of trade agreements, especially their impact on American jobs. This sentiment is unlikely to be directed towards Canada, however. Rather, most of their recent attention has focused on the large U.S. trade deficit with China. The Democratically-controlled Congress will likely put pressure on U.S. Treasury Secretary Paulson to urge the Chinese to speed up their exchange rate flexibility. Also, if any new trade agreements are to pass, they will likely contain stronger provisions regarding the environment and labour standards, as Democrats have expressed concerns on these issues in the past. This will be especially true after July 1, 2007, when the President's Fast Track Authority expires. These rules required Congress vote up or down on trade agreements negotiated on the President's behalf without the ability to alter the provisions. This is likely to stall new efforts after that time, but would have no material impact on Canadian trade.

Control of Congress does give the Democrats the ability to set the agenda by appointing the chairman for each Congressional committee, as well as the ability to subpoena individuals to testify before Congress. This oversight role will increase in importance relative to its use under the past Republican-controlled Congress. It will likely be similar to what was seen during the Presidency of Bill Clinton when Republicans won control of Congress two years into his Presidency. In that case, there were sharp debates over legislation but ultimately, the executive and legislative branches came to mutual agreements on the issues of importance.

At that time, the federal budget process also became a hotly contested topic and resulted in a widespread federal shutdown. We do not expect such a drastic outcome in the next two years. During the Clinton Presidency, the Republican-controlled Congress was seeking to bring fiscal restraint by limiting social spending. In this case, the Democratically-controlled Congress will likely want to reinstate some social spending and would likely not want to be seen shutting down the federal government in order to limit military spending. There is also no need to vote on tax cuts which are not set to expire until 2010, though it is possible the parties would extend a limited number of those cuts – especially those targeted at the middle class – rather than waiting until after the 2008 Presidential elections. It would be in no incumbent's best interest to allow a logjam to ensue coming into their 2008 reelection bids.

U.S. FEDERAL SPENDING



*U.S. Office of Management and Budget (OMB) forecasts for 2006-2011; **Source: OMB

Control will not formally transition until January 2007. By that time, TD Economics forecasts that the slowdown in the U.S. economy will already be at or near its trough. The U.S. economy will continue to accelerate through 2007. But once again, the issues of importance for the American voters and the Democratic Party seem to be of limited importance for the Canadian economy. Therefore, we expect little to no impact on the Canadian dollar, Canadian financial markets, or our current economic forecast.

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