Relax, the sky's not falling

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OTTAWA — The notion that the Canadian economy automatically follows where the U.S. leads is so widespread that Thursday's warning by Federal Reserve Chairman Ben Bernanke of further deterioration south of the border is likely to produce a great deal of gloom in Canada.

Is it warranted?

There are plenty of analysts who say it is. They point to the fact that the U.S. takes three-quarters of all our merchandise exports, not to mention all the other financial interconnections between the two countries, as reason enough to believe that our fortunes are inextricably linked.

However, there is a good case to be made that Canada, while not poised for a stellar year, will not suffer greatly. That case is built on three main points: The Canadian economy is in good shape and many of the apparent weaknesses at the end of last year largely disappeared in January; Canada's dependence on the U.S. market is overstated; and the U.S. economic situation may not be as dire as predicted.

All the major indicators of economic health are strong in Canada. Unemployment at 5.8 per cent is lower than it has been in more than three decades. Inflation at 2.4 per cent remains under control. Exports hit a record high last year, as did imports.

The federal government and many provincial governments have budgetary surpluses. Corporate profits are high. And although the merchandise trade surplus shrank to $49.7-billion in 2007, it was still a surplus, compared with the rather alarming U.S. trade deficit of $711.6-billion (U.S.) for the same year.

The factors that Mr. Bernanke identified as dragging down the U.S. economy, notably housing, financial turmoil, and high energy prices, are not acting in the same manner in Canada. The housing market here is still strong, the financial turmoil has been muted, and high energy prices benefit the Canadian economy because we are a net energy exporter.

It is true that North American auto manufacturers and forest companies are struggling. And for people working in those industries, the outlook is not good. Still, Canada produced more vehicles in 2007 than in 2006, which may come as a surprise to people used to reading bad auto news. And a huge drop in auto production in December, which some suggested heralded an even steeper slide, was due in large part to General Motors closing its Oshawa plant to change over to a new model. That plant will be up and running again this year.

The problems in the manufacturing sector in general pre-date any softening in the U.S. economy and will continue even once the U.S. recovers. They have more to do with low-cost competition from abroad and the strong Canadian dollar than with what is happening south of the border.

Canada's reliance on the U.S. is also much less than the straight merchandise trade figures suggest. While 76 per cent of our exports went to the U.S. last year, some were merely passing through, in transit to other countries. How much is not clear, because the trade statistics do not capture those data.

Those same trade figures showed that in 2007, Canadian exports to countries other than the U.S. grew significantly, reducing our dependence on the U.S. market. China, which just supplanted Canada as the most important exporter to the U.S., is a growing market for Canadian goods, as is the European Union. The more we sell to them and the less we sell to the U.S., the less tied we are to U.S. fortunes.

More important, many of our exports to the U.S. include a large amount of imported parts or material. For example, by some estimates, a car exported from Canada contains about 50 per cent of imported parts purchased from the U.S. and other countries. We rely on the U.S. to buy our cars, but our southern neighbour also relies on us to buy the components.

None of this is to say that we have completely decoupled from the U.S., merely that the impact of a recession there on the Canadian economy would not be as severe as commonly thought.

The last point supporting the case that Canada will not suffer as greatly this year is that there is no proof yet that the U.S. is actually facing a recession. Mr. Benanke did not use the word in his testimony before Congress Thursday. Instead, he referred to sluggish growth, which doesn't sound great but is at least better than an economic contraction.

This probably won't stop lots of economists in the U.S. from continuing to forecast a recession. But what must be remembered is that many of those economists work in the financial sector, which has been one of the hardest hit by the housing credit crisis. Their outlook is understandably gloomy, but does it hold true for the whole country?

Here in Canada, the Prime Minister and federal Finance Minister have been tending toward the negative these days in their economic statements. But whether they truly believe the economy is slowing, or whether they just want to dampen expectations of spending programs and tax cuts ahead of the Feb. 26 budget is anyone's guess. Under-promising and over-delivering is generally a successful political ploy.

So should Canadians be buying hard hats in anticipation of the sky falling in the U.S.? For the moment that looks like a waste of money.