

What the US Stimulus Package Means for the Canadian Recovery

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Although officials at the Bank of Canada remain cautious about growth prospects for the rest of 2009, they appear to be very upbeat about the economic outlook for next year. So much so that their 4% real GDP growth call for 2010 is twice our forecast (Chart 1). Such a strong bounce-back in economic activity is largely based on the hope that a favourable sectoral distribution of the US recovery will lift Canadian exports. That would not be unusual in the wake of a normal recession. But the nature of the budding recovery will be very different than what we have seen in the past, with US consumer spending taking a back seat to government stimulus. Add in the bite of US protectionism, and the benefit to Canadian exports is likely to be much more modest this time around.

Not Your Father's Economic Recovery

As usual, the Bank's GDP forecast is based on an array of assumptions including the value of the Canadian dollar and the level of interest rates. But because of the central role that US demand plays in the Canadian economy, its key forecasting tool is its "US activity index". That index is supposed to measure how economic growth in the US will translate into growth north of the border by weighting specific US demand and production variables according to the relative size of the related category in total Canadian exports. While that would normally be a very reasonable approach to estimating Canadian economic output,

relying on the historical linkages between Canada and the US to predict next year's GDP is a risky proposition, given that the upcoming US recovery will be all but typical.

Every past US economic recovery in the post-war era has been led by the consumer sector, with an average contribution of more than 3 percentage points to GDP growth in the first year after a recession. By contrast, the average contribution of total government spending to the early stages of any post-war recovery has been negligible. Unfortunately for Canada, the 2010 recovery will turn this pattern on its head.

The new American consumer is a shadow of his former self. Deleveraging and rising saving rates, along with a still weak labour market, suggest that consumer spending will contribute a mere 0.4 percentage points to 2010 growth, while at the same time hundreds of billions in fiscal stimulus dollars should boost 2010 real GDP growth by double that amount (Chart 2). With the public sector acting as the main driver of the US economy next year, any assessment of Canadian GDP growth must focus on how Canada-friendly President Obama's stimulus plan really is.

In Stimulus We Trust

To do that we need to take a closer look at the plan itself. Officially titled the American Recovery and Reinvestment

Chart 1
Two Views of Canada's Growth Outlook

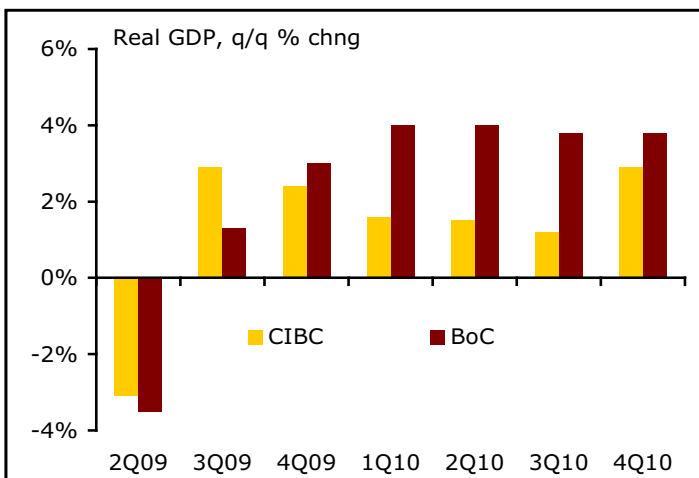


Chart 2
US Rebound Will Lean Heavily on Government

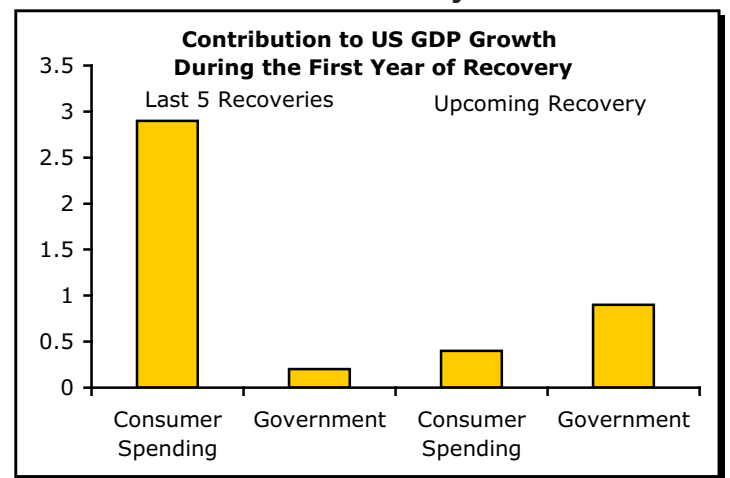
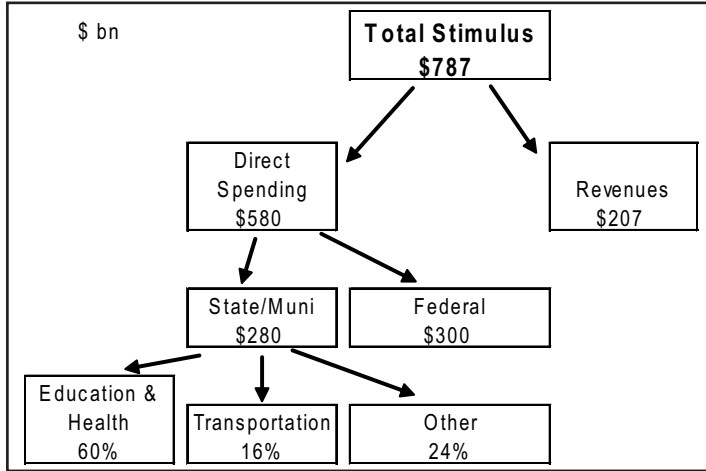
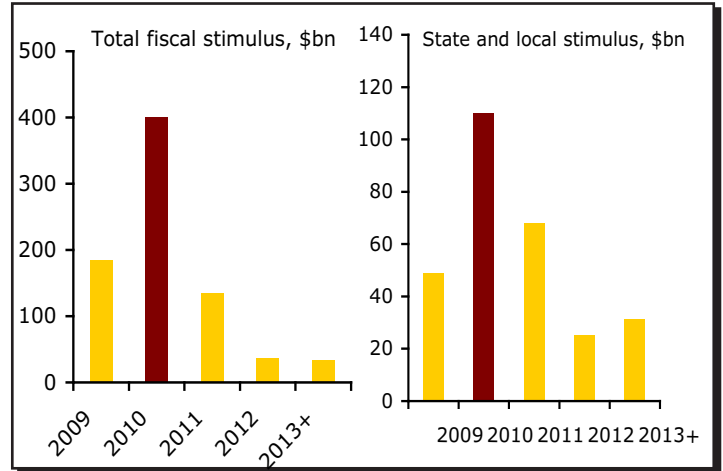


Chart 3
Where the US Stimulus Package is Going



Source: GAO

Chart 4
US Fiscal Boost Peaks in 2010

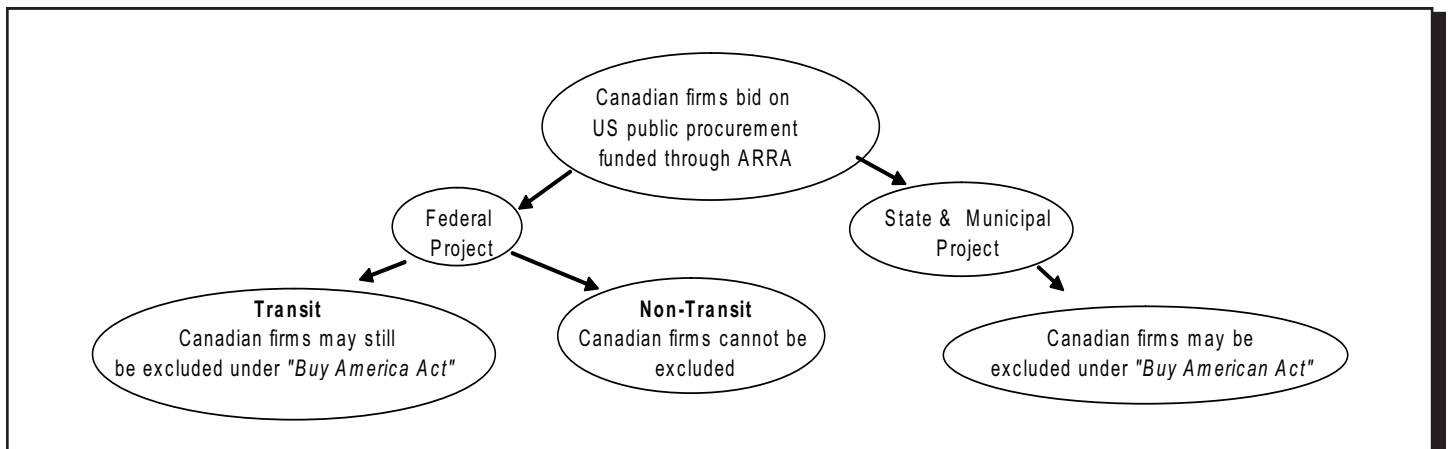


Act (ARRA), the \$787 bn US stimulus package is made up two main components, \$580 bn in spending measures and an additional \$207 bn in tax cuts and subsidies (Chart 3). Projections from the Congressional Budget Office (CBO) suggest that just over half of all stimulus spending will take place in 2010 (Chart 4). However, only 45% of that amount will take the form of tax provisions instead of direct spending. Although a portion of these tax provisions will make their way into the general economy, we can already see that a growing percentage of government tax cuts and supplements has been going directly into savings, not spending.

NAFTA and the WTO trade agreements largely prevent the federal government from restricting trade except in a few key areas like defense, approximately \$280 bn of the \$580 bn in total direct earmarked stimulus spending is being distributed at the state and municipal levels, which are much freer to restrict trade with Canada. Thirty-seven US states have committed to abiding by international trade commitments to one degree or another, but they can still close their procurement processes to Canadian firms because provincial governments have not made similar international commitments (Chart 5). That should be a particular problem in 2010 due to the fact that about one quarter of all ARRA spending next year will be administered by states and municipalities.

Furthermore, even the 55% of the stimulus dollars devoted to direct spending should have a reduced impact on the Canadian economy because of protectionism. Although

Chart 5
Where Protectionism Bites



Source: US Government

When it comes to protectionism the US economic stimulus package actually contains two separate protectionist provisions that will work to limit the impact that government spending can have on the Canadian economy. The first is the Buy American Act which stipulates that all goods for public use procured under the ARRA, including iron and steel, must be produced in the US with US materials.

The second restriction, known as the almost identically named Buy America Act, applies solely to grants issued by the Federal Transit Administration and Federal Highway Administration, and covers only transit-related procurements valued over US\$100,000. Unlike the broader Buy American Act, this legislation is not bound by NAFTA or the WTO agreements even at the federal level. Since the ARRA includes \$48 bn in pure transportation projects alone, Canadian firms could face significant trade barriers even at the national level.

Beyond Protectionism

That being said, protectionism is not the only roadblock that will work to dull the impact of massive US government spending on the Canadian economic recovery in 2010. Although the geographical distribution of the fiscal stimulus is roughly in line with each state's import intensity from Canada, the distribution across industries has a distinctly negative bias against Canada. In the absence of fully detailed data on the plan's industry distribution, we partially used the distribution of US employment gains, as identified by Obama advisor Christina Romer (Chart 6). In addition, we adjusted those

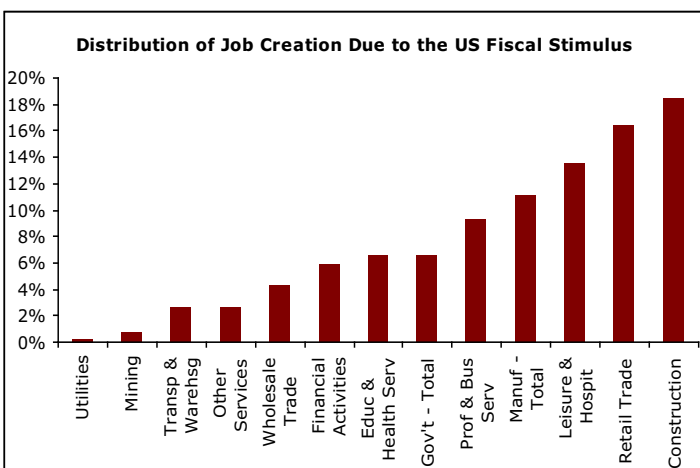
figures for the boost to retail and wholesaling from our own analysis of the impact of tax cuts on spending.

The spillover north of the border from the stimulus will then depend on the share of those US industries' inputs that have traditionally been sourced by imports from Canada. US Commerce Department data were used to track these shares, with the exception of two sectors (construction and utilities) where the absence of data required the use of inferences from Canadian export data.

As it turns out, even ignoring trade barriers, Canada's traditional participation in the sectors gaining from US stimulus has been less than impressive. Weighted by their direct benefits from the stimulus package, these industries import an average of 1.7% of their inputs from Canada. That's about one third lower than Canada's overall share of US GDP inputs (Chart 7). For example, much of the benefits will go to America's health, education and government sectors, all of which have marginal tendencies to import from Canada. Additionally, Canada's fuel and mining services sectors will see little benefit as their US target markets (utilities and mining respectively) reap comparatively less stimulus funding.

Thus, the sectoral distribution of an economy led by US stimulus spending, and the barriers of a high protectionist wall, will tend to dampen the benefits of America's recovery for Canada. Uncle Sam is in a spending mood these days, but fewer of those dollars will find their way north of the border than the Bank of Canada's official forecast implicitly assumes.

Chart 6
Which US Sectors Will See Stimulus Job Gains?



Source: Romer, CEA

Chart 7
Canada's Weighted Share of US Activity: Stimulus Winners vs Overall Economy

