



Economic Flash!

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Canadian Current Account for Q3 2010: A Reminder to Investors Long the C\$

\$Billion, Annual Rate	2008	2009	10:Q1	10:Q2	10:Q3
Current Account Balance	6.9	-43.5	-9.2	-13.0	-17.5
—Annual Rate			-36.7	-51.9	-70.1
Merchandise	46.2	-4.6	1.1	-2.2	-6.5
Services	-22.3	-22.7	-5.3	-5.6	-5.7
Investment Income	-16.4	-14.1	-4.9	-4.7	-4.2
Transfers	-0.6	-2.1	-0.1	-0.5	-1.2

- **The loonie's wingprints were all over this morning's current account data for Canada.** Our broadest measure of trade showed a record deficit of \$17.5 bn in the third quarter, from an upwardly revised \$13 bn deficit in Q2. The deterioration was worse than even our weaker-than-consensus call. The services trade deficit was flat while there was an improvement on the investment income balance. But those were swamped by the deterioration in the merchandise trade balance to the largest deficit on record. **The strong Canadian dollar encouraged businesses to invest in imported machinery in the third quarter, contributing to the massive goods trade deficit. But exports also didn't perform despite the recovery underway, clearly hampered by a loonie** that has, over the years, aided the erosion of our market share in the US. **The report is a reminder to investors that a significant further appreciation of the Canadian dollar will be hard to come by on trade fundamentals alone.**
- The services trade deficit was roughly flat as a better travel balance offset a deterioration on the commercial services trade account. The travel balance was helped by a large increase in the number of US residents entering Canada (the highest quarterly increase in over four years). That reflects, perhaps, better incomes south of the border, suggesting a stabilization in Canada's travel deficit (and hence the broader services trade deficit) going forward, barring, of course, another trade- and tourism-busting appreciating run from the loonie.
- The deficit in portfolio investment income widened further helped by foreigners acquiring more Canadian securities. But that was more than offset by lower net outflows of direct investment income. That allowed the investment income balance to improve by roughly half a billion dollars to a deficit of \$4.2 bn. But going forward, the investment income deficit will be under pressure to deteriorate, due to portfolio investment income outflows. Note that foreigners have ramped up their purchases of Canadian bonds in recent quarters, lured by relatively low sovereign risks and soft inflation. That trend partly explains why the deficit on Canada's portfolio investment income account has deteriorated in each of the last six quarters.

- Foreign direct investment in Canada fell for the first time since the recession, wiping out most of the gains in the prior quarter. The C\$ 9.2 bn drop in Q3 is attributed to repayments of debt by foreign firms to their parent companies, particularly those involved in the energy and metallic minerals sectors.
- The surplus on the capital and financial account well exceeded the current account deficit in the third quarter. In theory the sum of the current, capital and financial accounts should amount to zero, hence the massive \$4.9 bn “statistical discrepancy”, a category for unmeasured flows. The numbers may be overstating the net investment inflows.

Implications & Actions

Re: Economic Forecast — Canada is now running the largest deficit in 17 years (i.e. roughly 4% of GDP) despite being in a recovery. The Canadian dollar is, of course, the usual suspect. Note that since the loonie took flight in 2002, our share of US imports has been cut from 20% to under 15% today. With US demand restrained by a weak economy, and the upside to commodity prices capped by tighter monetary and fiscal policy globally next year, don’t expect major improvements on Canada’s current account. That should keep the Canadian dollar vulnerable should capital inflows dry up.

Re: Markets — The weaker-than-consensus current account balance did not seem to affect the Canadian dollar much this morning. Still, today’s report is a reminder to investors that, based on trade fundamentals alone, a significant further appreciation of the Canadian dollar is harder to justify.

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