Bennett Jones

ECONOMIC OUTLOOK

2024 MID-YEAR

Saving, Investment and Productivity Growth

The firm that businesses trust with their most complex legal matters.

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A NOTE FROM OUR CHAIR

Discussions with investors in Asia, Europe and the United States provide valuable insight into the state of Canada's economy. Views reflect reality and perception. Both matter. Investors universally envy our potential, our resource base, our human and intellectual capital, our access to the United States and other global markets, and our strong legal and financial frameworks. Even in today's uncertain world, many move forward with investments in our economy and commit to Canada long term. We celebrate such successes. But many observe unpredictable and disjointed policies and signals from governments and regulators that diminish prospective returns on investment, and so they choose to invest elsewhere. As a result, Canada leaves value on the table. We can do better.

This report prepared by our Public Policy group describes the state of our economy and its prospects for the short term. It sets out policy directions to catalyze more domestic and foreign investment and to grow our economic potential in a period of structural change.

John M. Mercury
Executive Chair and Chair of the Board

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Except where otherwise noted, the analysis in this Economic Outlook is based on published data available as of May 31, 2024.

Executive Summary

GDP PER CAPITA AND PRODUCTIVITY GROWTH: A LOOK BACK

Since 2006, the year before the onset of the Global Financial Crisis (GFC), real GDP per capita in Canada has grown at an average annual rate of 0.4%, well below the average of 1.6% of the prior years. Cumulatively, since 2006, our real income has grown by a disappointing 5.4%. On the trend of the prior 30 years, it would have risen by 35%.

The world has changed since 2006. We went through and recovered from not only the GFC, but also COVID. We signed trade agreements with European and Asia Pacific partners, renegotiated the North American Free Trade Agreement (NAFTA), then saw globalization stall in its tracks. We traded our Blackberries for iPhones and then witnessed the emergence of artificial intelligence (AI) partly pioneered in our own institutions. Start-ups emerged, some grew, many disappeared. Energy markets were transformed by the shale revolution and by policy to address climate change. Canadian oil production and exports expanded, we retired most of our coal plants, and we invested more in renewables. Our population grew older and we bolstered our immigration intake. Consumption and housing stayed robust, aided by rising levels of household debt. Governments broadly expanded programs and services. They borrowed, including to build infrastructure in response to the GFC, and then massively to fund transfers to individuals and loans to businesses during COVID. Inflation re-emerged and central banks around the world responded by tightening monetary policy. Geopolitical tension and wars brought national security and economic security into sharper focus.

Through the period, public and private debt rose, the Canadian current account went from a small surplus to a small deficit, and we redistributed large shares of income. Yet, per person, after inflation, we grew our economy by only 5.4%.

For sure, Canada is not alone in having experienced a slowdown of growth. The phenomenon is worldwide. However, other developed economies performed substantially better. From 2006 to 2023, real GDP per capita rose by 10.4% in Japan, 11.8% in the euro area, 19.6% in Australia, and 21.4% in the United States. The U.K., at 7.9%, is closest to Canada.

In addition to demographic and labour market changes, the major factor explaining the slowdown in GDP-per-capita growth is weaker productivity growth. GDP per hour worked in the business sector in Canada in Q1 2024 was 10.9% greater than in 2006; on the earlier trend, it would have been 28.9% greater. The slower productivity growth in the economy, in turn, is explained by lesser capital deepening—that is, lesser increases of capital (such as structures, and machinery and equipment [M&E]) per unit of labour. Importantly, both before and after the GFC, there was little contribution to productivity growth from better use of capital and labour, what economists call multifactor productivity, a rough proxy for innovation.

THE DETERMINANTS OF PRODUCTIVITY GROWTH: HOW WE MEASURE UP

Compared with other countries, in aggregate our saving and investment as a share of GDP is roughly average. However, we allocate a larger share of our national saving to investment in housing, even when accounting for population growth.

Per worker, we invest more in non-residential structures—for example, energy infrastructure—than most other developed economies, although substantially less than Australia. By contrast, our economy invests materially less per worker in M&E and intellectual property products (IPP) than most peer economies, and far less than the United States. For example—unlike in the United States—our businesses, in aggregate, did not ramp up investment in information and communications technology (including software) through the period of recovery from COVID.

To restore stronger growth in GDP per capita and to improve standards of living, our economy needs to invest more per worker and to innovate faster in the use of capital, technology and labour.

THE GLOBAL CONDITIONS: FRAGMENTATION AND STRUCTURAL CHANGE

Admittedly, global conditions do not appear particularly hospitable to business investment. The world is fragmented and beset by uncertainty. It is characterized by:

- geopolitical tension and a realignment of supply chains;

- trade friction and a rise of protectionism, including as may intensify in North America with a review of the Canada–U.S.–Mexico Agreement (CUSMA) in the offing;
- a baseline projection of modest growth of global demand for the medium term; and
- pressure on costs that, together with high levels of debt, are likely to keep real interest rates higher than pre-COVID even once inflation is back to target.

Globally, and in Canada, the policy signals affecting the energy transition and the digital transformation of our economies, two critical drivers of new investment, are uncertain. On energy and climate, while the direction is clear, policy is running ahead of markets: private investment is not matching what would be required to meet policy goals and commitments. By contrast, as regards digital technology and AI, policy is trying to catch up to markets. Investment must take into account a complex and evolving set of rules and standards.

These factors together pose significant risks and raise a wide range of plausible scenarios for the medium term. Some of the developments may depress investment. Yet, structural shifts and disruption also create opportunity. To be on the winning side of change, businesses have to make calculated bets and move forward with long-term strategies and investments.

Canada has assets and cards to play in global competition. And there are positive recent developments. The Trans Mountain Expansion pipeline is now in service. The Canada LNG project is well advanced. We have secured, at a cost, landmark investments in the battery and electric vehicle supply chains. There is world-class talent and a vibrant universe of start-ups at the leading edge of AI technology. Yet, there is much more to do just to keep up with global competition, let alone beat it.

A BASELINE SCENARIO TO THE END OF 2026

To assist business planning, we provide a baseline scenario for growth, inflation and interest rates for the United States and Canada to the end of 2026.

After diverging during 2023, the two economies are both projected to grow at an annual rate of about 2% through to 2026. We expect the U.S. economy to again rely on productivity improvement to achieve the projected 2% growth more heavily than in Canada where, as in the past, additional hours of work (i.e., more labour) are likely to play a more important role.

We expect inflation to reach the 2% target in Canada by the end of 2025 and in the United States by early in 2026. The Bank of Canada has begun cutting its policy interest rate, and the Federal Reserve is expected to follow in the second half of 2024. The Bank of Canada should make one or two additional quarter-point cuts by the end of the year. We think that the Fed is likely to cut once, by a quarter point, by year-end. Under our scenario, the policy rates in the two economies will be reduced at different paces, but to the same floor of 3.0% to be reached early in 2026.

We see long-term interest rates (i.e., 10-year government bond rates) remaining somewhat below 4.0% in Canada until the end of 2026, and in the United States trending down to the same level over the period.

THE OVERRIDING ECONOMIC POLICY GOAL: RAISING PRODUCTIVITY GROWTH

To continuously improve our standards of living, the overriding goal of economic policy for Canada must be stronger growth in productivity. It is by giving productivity-enhancing investment absolute priority that Canadians may continue in the future to have the income—and governments the revenue—to buy desired private and public goods and services, and to advance other critical pursuits.

Raising the share of GDP allocated to saving and investment today and in the medium term implies that a reduced share is available for current consumption. For households, this means increasing saving in some form as a share of current income. For businesses, it entails the reinvestment in productive capital of a greater share of earnings. For governments, it means allocating proportionately more resources to public investment that can generate a future stream of income, rather than enhancing current transfers.

A strategy that is laser-focused on productivity growth must have a medium-term horizon. It must give direction, predictability, consistency and coherence to the actions of government, and thus provide clear signals to investors. Investments in energy and resource infrastructure, as well as in research and development (R&D) and innovation, require a consistent policy framework that extends well beyond any political cycle. Details of that framework will evolve, in particular to respond to global developments, but there must be solid medium-term policy principles and anchors.

There is a role for every level of government in establishing the policy framework to raise Canada's productivity growth, and there should be both collaboration and accountability. The federal government has powerful levers, and it can exert national leadership. Yet, provinces, territories and local governments, and in some cases Indigenous governments, are on the front lines of policy development and especially delivery in key domains, and there must be some alignment of strategy, plans and actions.

Governments must have a credible medium-term fiscal framework under which promised services are realistically budgeted for and paid for from current revenues. While fiscal policy continues to have an important stabilization role, net borrowing over the cycle should be undertaken for the sole purpose of funding investments that grow productive capacity and yield an identifiable stream of revenue. A productivity focus by government also entails more attention to execution and delivery, the complex implementation work that comes after the policy announcements.

As technological and economic conditions evolve, productivity growth is achieved by the reallocation of resources—financial capital, skilled labour and leadership—to the most innovative and successful activities and enterprises, and away from less productive ones. Economists refer to this healthy process as one of "creative destruction." Governments must have a tolerance for disruption and a capacity to facilitate the adjustment of workers.

Federal and provincial governments, individually and working together, have to address all of their policy initiatives through the lens of productivity enhancements, designing their policies and programs in such a manner as to create a framework that best serves this overriding goal.

DOMAINS OF PRIORITY ACTION FOR GOVERNMENTS

In our last *Economic Outlook*, we identified five domains of policy priority: immigration, competition, taxation, frameworks for the digital economy and environmental regulation. All remain salient.

For example, on immigration we underscored the need to attract highly skilled individuals who can help raise output per worker, and to resist pressure simply to close gaps in low-paying occupations.

On taxation, a succession of recent federal measures illustrates the need for a coherent, integrated approach. We do not advocate a one-shot all-encompassing reform. However, there is a need for a continuing, stepwise effort, with annual instalments, founded on clear principles and with a focus on stimulating saving and risk investment.

There is a case also to review aspects of financial sector regulation to determine how more of the saving of Canadians can be channeled efficiently to productive investment.

At a difficult time for global economic relations, the federal government has a critical leadership role in positioning our economy internationally and working with provinces and businesses as Team Canada to manage risks and advance our interests.

Securing our relationship with the United States is top of mind. CUSMA was a success for our economic diplomacy. The next rounds—under any administration—may be more difficult. Managing our relationship with China while also building viable and resilient supply chains in North America, notably in electric vehicles (EVs), will be an equally delicate task. Broadly, we must find our way in a more fractious world without succumbing to protectionism, which would deeply damage our economic prospects.

THE IMPORTANT ROLE OF PROVINCES

Provinces are key players in support of some of the priorities cited above. For example, under Canada's 2024–2026 Immigration Levels Plan, 40% of economic immigrants will be admitted to Canada under the Provincial Nominee Program.

On all forms of regulation, provinces and municipalities loom large. Provinces are in the driver's seat on internal trade. The International Monetary Fund (IMF) in 2019 estimated that "complete liberalization of internal trade in goods could increase GDP per capita by about 4 percent." Progress to date has been glacial.

We cite two domains where provinces have the lead and where decisive action could accelerate the building of a clean, productive economy.

- The first is the expansion and decarbonization of the electricity grid. Under most estimates, a clean economy by 2050 requires doubling or more the capacity of our electricity system, including clean generation and transmission. Given long lead times to plan and execute investments, and the massive scale of the enterprise, the signals to public and private investors must be very clear. The federal government has introduced some policy instruments to support the effort. Provinces must drive planning and execution as a matter of priority.

- The second is industrial carbon pricing. It is the part of the carbon-pricing system that is expected to make the largest contribution to emissions reductions. Yet, the provincial systems are disconnected, even where the federal backstop applies. It is entirely within the authority of provinces to collaborate toward a harmonized and integrated system that would facilitate compliance, allow the trading of credits across the country, incentivize investment, and help achieve emissions reductions at the lowest cost.

IN SUM

There is no single federal or provincial policy or set of policies that, all else unchanged, could alter decisively and quickly trends in saving, investment and productivity growth.

Moving the needle will take time, and it will require a coherent and complementary set of actions by federal and provincial governments working together with businesses.

Overall, both business strategy and government policy must converge toward raising output per worker and GDP per capita. If, alternatively, this goal is subsidiary to all other important pursuits, then we will be dividing a static or shrinking pie and likely falling further behind other nations.

CHAPTER 1

GDP per Capita and Productivity Growth: Trends and Drivers

It is now widely recognized that GDP per capita in Canada has been stagnating and that this is largely attributable to a slowdown in productivity growth. More recently, GDP per capita has declined in absolute terms.

A historical analysis and international comparisons draw out key points:

- While it has been exacerbated since COVID, deceleration of growth in productivity and GDP per capita started as early as the onset of the GFC of 2007–2008.
- Canada has not been alone in experiencing a slowdown over this period.
- However, Canada has performed worse than many other developed economies.
- Aggregate saving and investment in Canada are average compared to some of our global peers.
- Proportionately, Canada has allocated a larger share of its saving to housing than all of its global peers, and correspondingly a smaller share to productive investment.
- Our businesses invest far less per worker than their competitors in the developed economies.

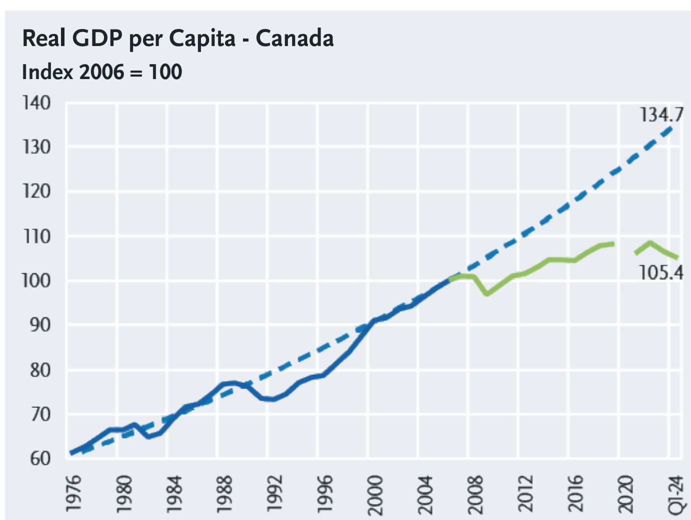
To grow productivity and GDP per capita while also addressing housing gaps, we need to both raise aggregate saving and shift more of our saving to investment in productive capital.

TRENDS IN GDP PER CAPITA AND PRODUCTIVITY

Real GDP per capita in Canada in the first quarter of 2024 was 2.4% lower than in 2018 and only 5.4% higher than in 2006, far below where it would have been if pre-2006 trends had been sustained (Chart 1.1). Since 2006, the average annual rate of growth in GDP per capita is 0.4%. This pales with the trend growth rate of the prior years of 1.6%. Clearly, the GFC, while not disrupting the financial system in Canada to the same extent as in the United States, had profound, lasting impacts on our economy, including through shocks to demand for our exports.

Weaker productivity growth is the major factor explaining the slower growth of GDP per capita since 2006. While GDP per hour worked grew at an average annual rate of 1.54% through the 1976–2006 period, it has since grown at an average rate of only 0.6% (Chart 1.2). Demography and labour market factors also contributed to the slowdown in GDP per capita growth. In the years 2001 to 2006, when trends were broadly typical of the 1976–2006 period, there was a rising share of the population that was

CHART 1.1



Source: Statistics Canada, tables 36-10-0104-01, 17-10-009-01 and 17-10-0005-01.

TABLE 1.1

Contributions to GDP per Capita Growth, 2007–2023 vs 2001–2006						
	GDP per Hour Worked	Working-Age Population as Proportion of Total Population	Labour Force as Proportion of Working Age Population	Employment as Proportion of Labour Force	Hours Worked per Worker	GDP per Capita
2001–2006	1.4	0.4	0.4	0.1	-0.4	1.6
2007–2023	0.6	0.1	-0.1	0.1	-0.2	0.4
Change	**-0.7**	**-0.3**	**-0.5**	**0.0**	**0.2**	**-1.2**

*The analysis is this table is based on data to the fourth quarter of 2023, as available prior to May 30, 2024. *Sources: Statistics Canada tables 36-10-0480-01,36-10-0104-01,17-10-0005-01, 14-10-0287-01.*

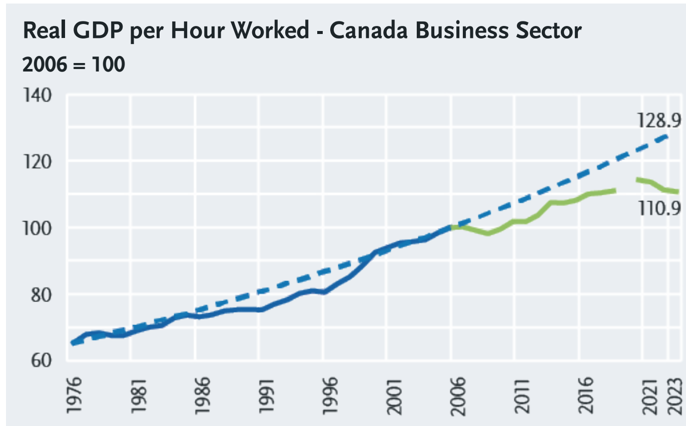
working age, together with a rising rate of participation in the labour force (Table 1.1). A diminution of average hours worked per worker only partially offset the impact of these two factors on GDP per capita growth. After 2006, the share of the population of working age essentially plateaued, the participation rate declined modestly, and this was mitigated only marginally by a slower decline in hours worked than in the previous period. Together, these demographic and labour market factors eroded gains from modest productivity growth, such that, overall, GDP per capita has been close to stagnant since 2006.

The lower average growth in output per worker since 2007 in turn is explained by lesser capital deepening—i.e., lesser growth of capital per unit of labour—than over the prior period (Table 1.2). The contribution of rising capital intensity to productivity growth was nearly halved over the period 2007–2022 compared with the benchmark of the previous five years.

Importantly, both before and after the GFC, Canada recorded dismal multifactor productivity (MFP) growth. Thus, not only have our businesses built up less capital per worker since 2006, they have not succeeded, on average, in generating material gains in productivity from better use of capital and labour. MFP is a residual, the part of changes in output per worker that is not explained by changes in the capital intensity or in the composition of labour. It is a proxy for innovation and for the intangible factors that can weigh heavily on productivity. A deeper dive into reasons for this poor performance by Canada is beyond the scope of this report.

While Canada has not been alone in experiencing slower growth in GDP per capita since the GFC, it has performed substantially worse than not only the United States but many other developed economies (Chart 1.3). It is unfair—albeit interesting—to compare Canada's 6.8% cumulative growth in GDP per capita through the period, or 5.4% if one includes the first quarter of 2024, with that of Korea (54.1%) because the two economies are at different stages of development. However, it is appropriate to compare Canada with other resource-based economies like Australia (19.6%) and New Zealand (17.1%), and other G7 economies like the euro area (11.8%), Japan (10.4%), the U.K. (7.9%), or, of course, the United States (21.4%). Not surprisingly, the countries closest to Canada in this ranking, Japan and the U.K., are having intense debates at home about their economic direction.

CHART 1.2



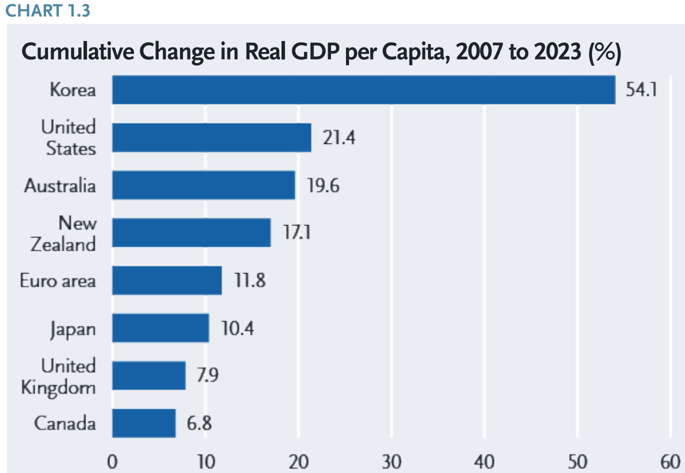
Source: Statistics Canada, table 36-10-0480-01.

TABLE 1.2

Contributions to GDP per Hour Worked, Business Sector 2007–2022				
		Contributions from changes in		
	GDP per Hour Worked	Capital Intensity	Labour Composition	Multifactor Productivity
2001–2006	1.3	1.12	0.29	-0.12
2007–2022	0.8	0.62	0.26	-0.08
Change	**-0.49**	**-0.50**	**-0.03**	**0.04**

Source: Statistics Canada table 36-10-0208-01.

CHART 1.3



Sources: International Monetary Fund (World Economic Outlook Data, April 2024) and Eurostat.

INTERNATIONAL COMPARISONS OF SAVING AND INVESTMENT

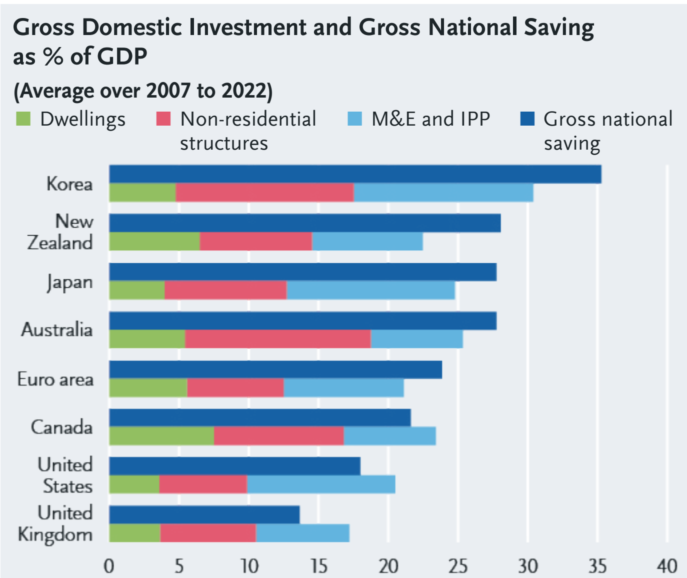
Canada falls short in international rankings of key determinants of growth; in particular, our economy is less successful than many of its peers in mobilizing domestic saving to build capacity and raise productivity.

At an aggregate level, our disadvantages are not stark; as a share of GDP, our gross national saving and gross domestic investment are lower than those of some countries, higher than those of others. Over the 2007 to 2022 period, we saved and invested a lesser proportion of our GDP than Korea, New Zealand, Japan, and Australia (Chart 1.4). We saved less, but invested more, than the euro area. We saved and invested more than the U.K. and, surprisingly, the United States. Our investment over the period exceeded our domestic saving as we ran current account deficits that were financed by a net inflow of foreign saving. As described in the Annex, the net inflow of foreign saving was mostly allocated to debt securities, not portfolio equity or direct investment.

Breaking down aggregate investment over recent periods, and expressing it in amounts per capita or per worker, shows more clearly how Canada compares with its international peers.

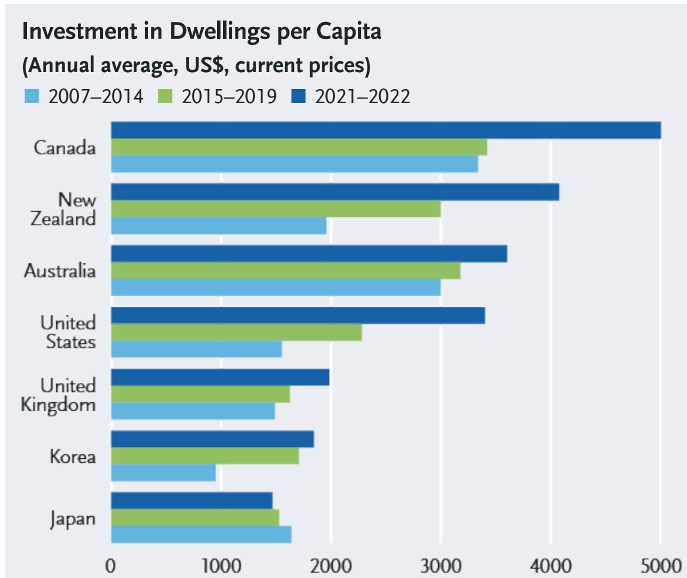
Canada invests far more than its peers in housing, even where population growth is comparable. As shown in Chart 1.4, through the period 2007–2022, we allocated a higher share of our domestic saving to housing than any of the economies in our peer group. In U.S. dollars per capita, we invested far greater amounts annually than even Australia or New Zealand, which also had high rates of population growth (Charts 1.5 and 1.6). All developed economies boosted residential investment in the post-COVID period, but Canada further distanced itself from the rest.

CHART 1.4



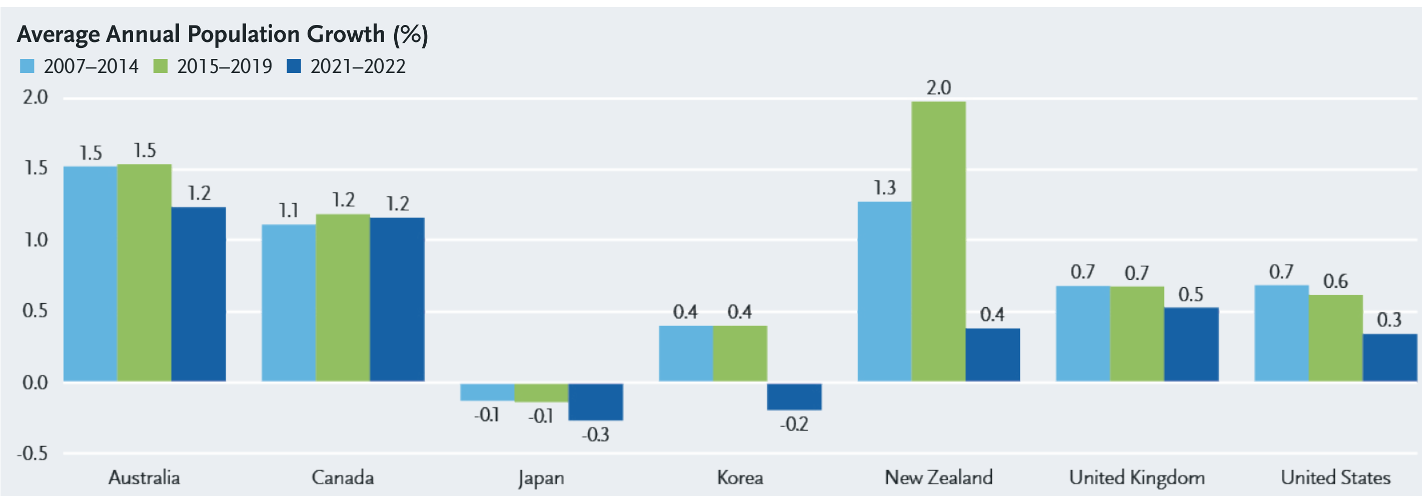
Source: OECD, data-explorer.

CHART 1.5



Sources: OECD data-explorer and IMF WEO Data April 2024.

CHART 1.6



Source: IMF WEO Data April 2024.

Canada has invested more per worker in non-residential structures—including, for example, energy infrastructure—than most other developed economies, but substantially less than Australia (Chart 1.7). The ranking of countries for investment in structures has been stable since 2007, despite fluctuations in commodity prices. Australia's robust performance and advantage over Canada over the period enabled, in particular, responsiveness to the fast-growing demand for energy and mineral commodities from China. This was an important factor favoring strong GDP per capita growth in Australia, compared with Canada and many other economies.

By contrast, per worker, Canada invests less annually in M&E and IPP than most peer economies, and the gap in the period of COVID recovery has widened materially (Chart 1.8). Our businesses, on average, are taking less advantage of technology to lift productivity than their global peers, and investing less per worker in intellectual capital to gain a competitive edge. The gap relative to the United States is striking, and it is getting worse. In 2021 and 2022, on average Canada invested the equivalent of US$6,400 per worker in M&E and IPP, compared with US$17,794 for the United States—almost two-thirds less. In our *Economic Outlook* of December 2023, we expanded on Canada's poor international ranking in such related drivers of productivity growth as expenditures on R&D and the creation, ownership, and commercialization of intellectual property (IP).

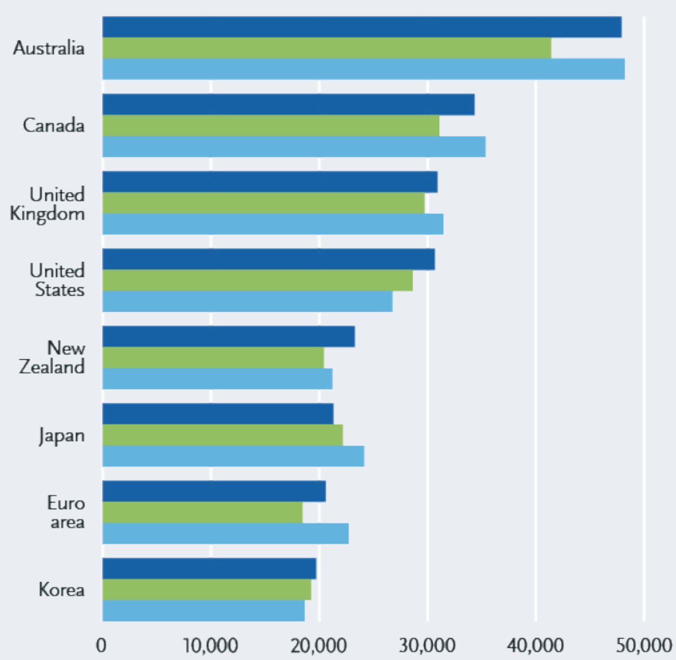
When it comes to information and communications technology (ICT) and software, the striking observation is that unlike the United States, Canada (and some global peers) have not ramped up investment in recent periods to capitalize on digital transformation (Chart 1.9). There was reason to expect that business adjustment to COVID would have created strong momentum toward investment in digitalization. Yet Canada has grown only modestly its investment per worker in ICT (including software) compared with pre-COVID levels. With the rapid emergence of AI technology and the early head start of U.S. big tech in creating the major platforms, early and substantial growth in investment is necessary to deploy the technology and to develop new applications and databases for commercial advantage across all sectors of the economy. At the moment, Canada is losing ground. A ramp-up of investment is critical just to stay in the game.

CHART 1.7

Investment in Non-Residential Structures per Worker

(Annual average, US$, current prices)

2007–2014 2015–2019 2021–2022



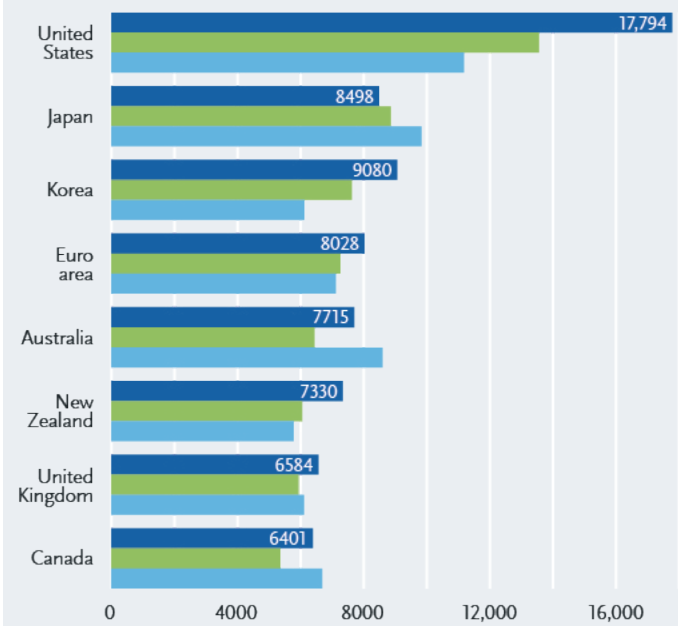
Sources: OECD data-explorer and IMF WEO Data April 2024.

CHART 1.8

Investment in Machinery and Equipment and Intellectual Property Products per Worker

(Annual average, US$, current prices)

2007–2014 2015–2019 2021–2022



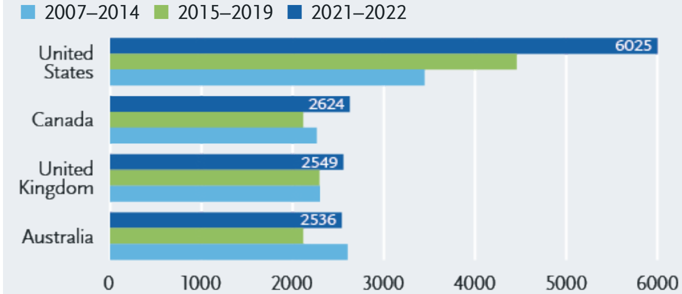
Source: OECD data-explorer and IMF WEO Data April 2024.

CHART 1.9

Investment in Information and Communication Technologies (Including Software) per Worker

(Annual Average, US$, current prices)

2007–2014 2015–2019 2021–2022



Source: OECD Data Explorer.

N.B. The number for Canada over 2021-2022 is an estimate as OECD data for ICT in Canada for 2022 is incomplete.

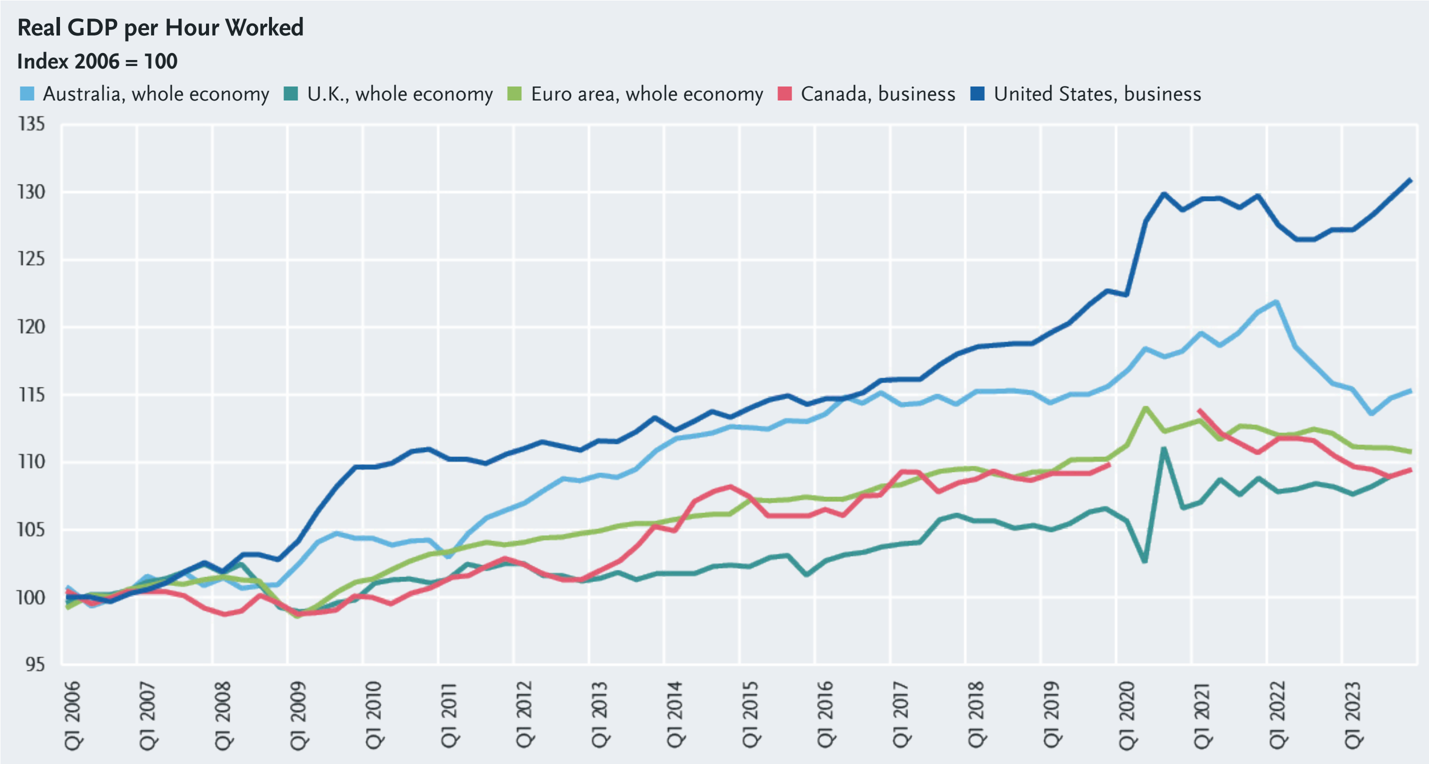
CONCLUDING OBSERVATIONS

Canada can draw lessons from peer economies that have been more successful in mobilizing saving, investing in productive capital, and raising productivity and GDP per capita. With strong investment in structures, Australia has been capitalizing on the growth of China and on rising global demand for liquid natural gas (LNG) and mineral resources. For its part, the United States has shown a remarkable capacity to build advantage as it pulled out of crises. It has invested consistently more than other economies in M&E and IPP, particularly in ICT. After both the GFC and the COVID epidemic, the U.S. economy had a burst of investment and productivity gains (Chart 1.10). The two crises caused disruption but then led to innovation and adjustment in a manner not matched by most other economies.

While this *Economic Outlook* focuses on investment and productivity growth to lift GDP per capita, developments since 2006 have also highlighted the importance of demographic and labour market factors that require complementary business and policy strategies. An immigration policy that enhances our human capital, improved incentives for participation in the labour force including for older workers, and public and private investment in skills development have to be pursued jointly with efforts to mobilize saving and investment. In all of these domains of business and policy, there is potential to do much better.

Similarly, beyond raising saving and investment per worker, better use of capital and labour could make important contributions to productivity and GDP per capita growth. Multifactor productivity is a less tangible but no less important factor in determining output per worker. For businesses, it brings into play the capacity to realize value from innovation, including by commercializing valuable intellectual property. Digitalization and the role of intangible assets in driving the growth and profitability of firms make even more pertinent today policy and business attention to this component of productivity growth.

CHART 1.10



Sources: Statistics Canada, table 36-10-0206-0, U.S. Bureau of Labor Statistics, U.K. Office for National Statistics, Eurostat, and Australian Bureau of Statistics.

CHAPTER 2

Structural Change in a Fragmented Global Environment

Correcting trends in productivity growth while adapting to structural change requires a surge in investment and innovation that businesses have to plan and execute in an uncertain and fragmented global environment.

In assessing investment opportunities, business strategies have to be responsive to key factors affecting the medium-term outlook globally.

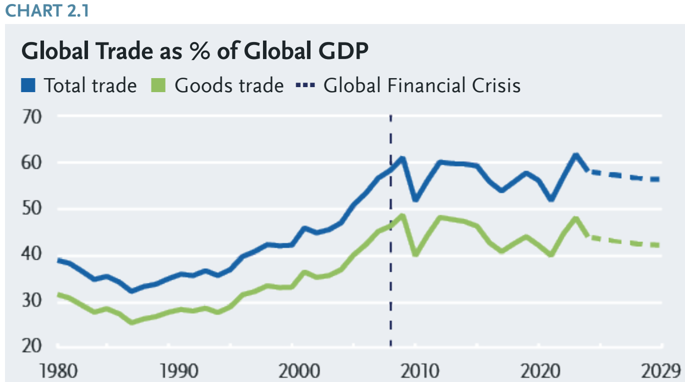
- Geopolitical tension and a realignment of supply chains.
- Trade friction and a rise of protectionism, which may intensify in North America with a review of the CUSMA in the offing.
- A baseline projection of modest growth of global demand by historical standards.
- Pressure on costs that, together with high levels of debt, is likely to keep real interest rates higher than pre-COVID.
- Uncertain policy signals affecting the prospective returns and risks of the large private investments required for the energy transition and the digital transformation of our economies.

These factors together raise a wide range of plausible scenarios for the medium term. Some of the developments may depress investment. Yet, strictly defensive, risk-averse strategies are unlikely to succeed. Businesses have to make calculated bets.

GEOPOLITICAL TENSION AND GEOECONOMIC FRAGMENTATION

Geopolitical tension and conflict to date have not diminished aggregate global trade, but a realignment of trade flows and supply chains is underway, including a partial decoupling of the U.S. and Chinese economies. Since the GFC, global trade has no longer been growing faster than aggregate GDP, and thus it is not the same engine of growth as it was in the 1980s, 1990s, and early 2000s (Chart 2.1). Over the medium term, the IMF expects global trade of goods and services to continue to grow more or less in line with GDP. At the same time, geopolitical rivalry and related trade policy actions, as well as businesses' efforts to build greater resilience into their supply chains, are reorienting trade flows. Since 2018, trade between the United States and China has grown 30% less than their trade with the rest of the world (Chart 2.2). The Biden administration, which left in place the tariffs imposed on Chinese imports by President Trump, doubled down in May 2024 with action "carefully targeted at strategic sectors," including EVs (quadrupling of the tariff to 100%), lithium-ion EV batteries (25%), solar cells (50%), and steel and aluminum (25%).[1] The measures aim to counter "China's unfair trade practices" and to protect the large private investments in domestic capacity spurred by the *Inflation Reduction Act* and the *Chips Act.*

CHART 2.1

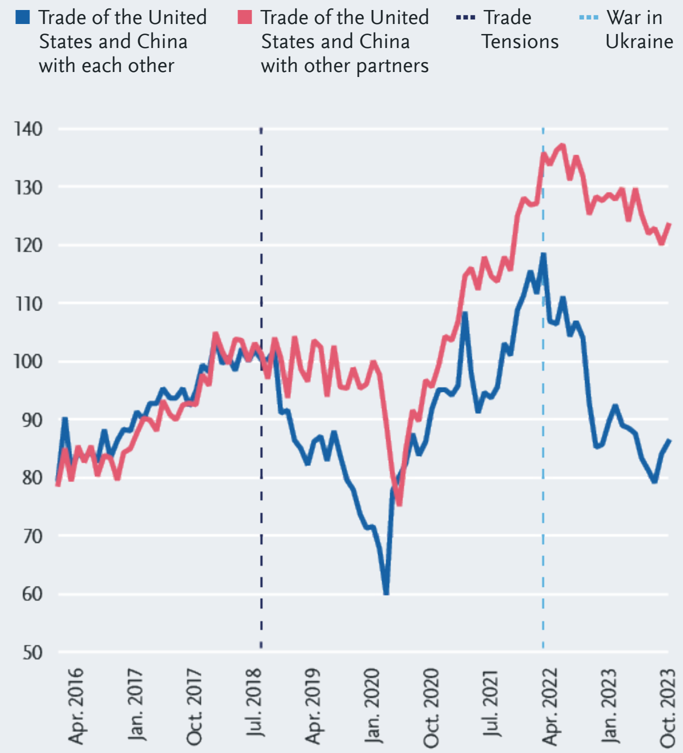


Source: IMF, WEO, April 2024.

CHART 2.2

Trade Between the United States and China and With Other Partners

Index, June 2018 = 100

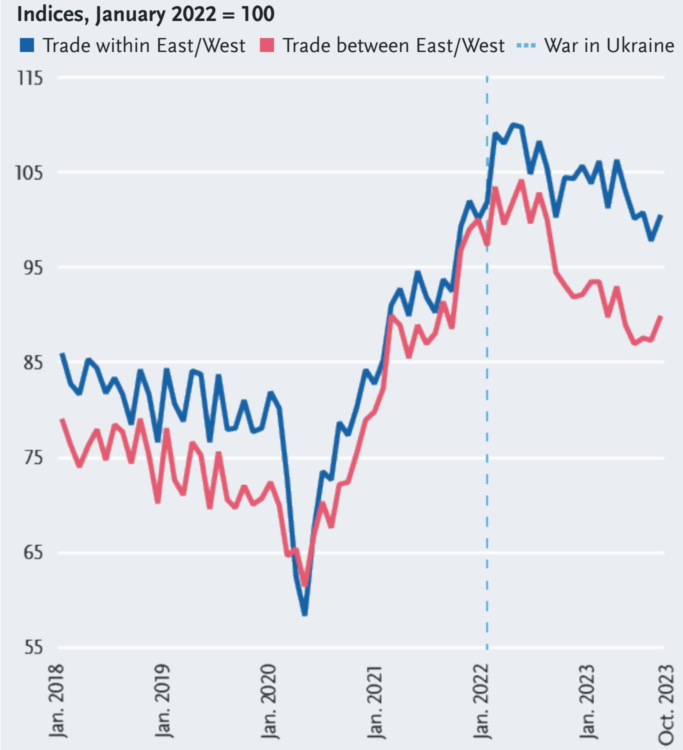


Source: WTO, Global Trade Outlook and Statistics, April 2024.

CHART 2.3

Trade Between and Within Hypothetical Trade Blocs

Indices, January 2022 = 100



Source: WTO, Global Trade Outlook and Statistics, April 2024.

Since the invasion of Ukraine by Russia in early 2022, there has been some shift of trade from *between to within* geopolitical blocs (Chart 2.3).

Near-shoring can advance strategic objectives and strengthen the security of supply chains, but together with protectionism and preferences for domestic producers under industrial policy, it can impose significant costs. The IMF estimates that in a severe scenario the separation of the global economy into two blocs could reduce global GDP over the long term by as much as 7%.[2] Geoeconomic fragmentation can also affect cross-border investment and capital flows, potentially raising the cost of capital. It can slow down the rate of diffusion of technology. Clearly, it diminishes needed cooperation on such global problems as climate change and pandemics.

The realignment of supply chains can also create opportunity for Canadian producers. Since 2018, the United States has narrowed its trade deficit with China but accentuated its trade deficit with Mexico, the euro area, other Asian economies, and Canada.[3] The U.S. trade balance with Canada went from a surplus of US$6 billion in 2018 to a deficit of US$47 billion as growth in the value of U.S. imports from Canada outstripped growth in the value of exports to Canada. In the ICT services sector, from 2018 to 2023 U.S. imports from North American trading partners (mostly Canada) increased from 15.7% of total imports to 23.0%.[4]

TRADE FRICTION AND COMPLEXITY

Protectionism and industrial policy can also impede trade among geopolitical allies; for Canada, U.S. political dynamics pose serious risks. There is cause for concern, for example, about the 10% across-the-board import tariff proposed by presidential candidate Donald Trump. The global ramification of such an action—and retaliation by global partners—would be profound. Regardless of who is elected president, and whatever the future composition of the two houses of Congress, there will be no easy ride for Canada. Indeed, the relationship with the current administration is not tranquil. At the fourth meeting of the CUSMA Free Trade Commission on May 22, the United States reiterated its concerns regarding the access of U.S. producers to our dairy market and Canada's proposed digital services tax. In January 2023, an arbitration panel ruled in favour of Canada and Mexico and against the United States on the matter of content rules in the automotive sector. However, the Biden administration has delayed compliance with the ruling, wishing to address the matter in the context of its efforts to keep Chinese imports out of the EV supply chain.

The joint review of the functioning of the CUSMA to be concluded on the sixth anniversary of the Agreement, or July 1, 2026, could trigger a potentially difficult renegotiation. U.S. trade representative, Katherine Tsai, described the uncertainty this poses for the trading partners:

You do not want that review to happen in a way that all three parties come to the conversation too comfortable. ... The whole point is to maintain a certain level of discomfort—which may involve a certain level of uncertainty. To keep the parties motivated to do the really hard thing, which is to continue to re-evaluate our trade policies and trade programs. ... That discomfort is actually a feature—not a bug.[5]

Canadian businesses must navigate a complex trade environment while also managing their supply chains and complying with new disclosure and accountability requirements. Canadian firms can capitalize on a large set of trade agreements with major global economies and secure support from a vast network of trade commissioners, as well as from entities such as Export Development Canada. However, an expansion of restrictive trade measures internationally, a multiplication of regional or sectoral trade arrangements, and a bolstering of industrial policies have fragmented markets and complicated the conduct of international business. Added complexity for international businesses has also come from compliance with a range of new disclosure and accountability requirements related to climate and to environmental and social practices across supply chains.

MODEST GLOBAL DEMAND GROWTH

In part because of geoeconomic fragmentation, the IMF projects global real GDP growth of 3.1% for the medium term, well below historical trends. For example, before the GFC, the projection was 4.9%. Actual growth over 2000–2019 averaged 3.8%. The reduced projections are consistent with a global slowdown of productivity growth, which in turn can be explained by lesser gains in efficiency in the allocation of capital and labour. Structural frictions prevent capital and labour from moving to productive firms. Growth projections are also muted by the scarring effects of the pandemic and by the impact of the war in Ukraine.

The key takeaway for Canadian businesses is that, over the foreseeable future, global demand will not produce a tide to lift all boats; to grow output and exports meaningfully, despite a challenging trade environment Canadian businesses will need to achieve gains in market share.

COST PRESSURES AND REAL INTEREST RATES

In the medium term, supply constraints, the fragmentation of the global economy, and structural change such as a transition to cleaner forms of energy are likely to push up producer costs. Demographic trends, and limits to immigration, are constraining the supply of workers. Globalization is no longer assuring a rising supply of cheap final and intermediate goods. While technology is reducing some costs, large investments in new energy systems will have to be recovered from users. New sources of critical minerals may not come on stream as quickly as needed.

Concurrently, long-term forces will tend to depress global savings while the demand for investment is robust. Aging households may be expected to reduce their saving. Meanwhile, governments are projected to continue to dissave (i.e., to borrow) as they confront competing pressures to respond to the needs of an aging population, bolster their defence capabilities in an uncertain world, and make public investments, notably to support the energy transition. Global public debt is projected by the IMF to approach 100% by 2029, driven by the United States and China.[6]

Together, these factors are expected to place upward pressure on real interest rates such that we are unlikely to return to the very low short- and long-term rates that prevailed in the years preceding COVID.

POLICY AND MARKET SIGNALS FOR STRUCTURAL CHANGE

Investments will be driven largely by structural changes in the economy on a global scale—namely, the energy transition and the digital transformation of the economy, including the development and diffusion of AI.

While the direction of change is clear, the pace of change and its ramifications across the economy are highly uncertain, in part because policy and business drivers are not in sync.

On energy and climate, policy is running ahead of markets: private investment is not matching what is required to meet policy goals and commitments. The International Energy Agency (IEA) observes that while investment in clean energy reached a record US$1.8 trillion in 2023, far surpassing investment in fossil fuels of US$1.1 trillion, it would have to grow to US$4.5 trillion annually by 2030 for the global economy to be on a path to net zero by 2050, the target endorsed by some 120 countries, including Canada.[7] Global energy-related emissions reached a record in 2022, and they have not yet peaked. Domestically, progress toward even the interim target of 40% emissions reduction by 2030 is modest. In 2022, our emissions were up slightly from 2021 and down only 7.5% from 2005, the base year for the 40% target reduction by 2030.[8]

While the Paris Agreement of 2015 and the Nationally Determined Contributions establish a legally binding framework for the pursuit of climate goals, it remains unclear how the tension between goals and market outcomes will ultimately be resolved.

- Domestically, despite the introduction of generous tax credits, major investments to advance climate goals, such as large carbon capture and sequestration (CCS) projects in the oil sands or in the power sector, are still held back because of uncertain economics. Meanwhile, some provinces and utilities challenge the feasibility of achieving a federal target of a net-zero electricity system by 2030 without compromising energy reliability, security, and competitiveness.[9]

- The tension between policy and markets will be exacerbated if the United States elects an administration and a Congress that again pull the United States out of the Paris Agreement and roll back climate regulation.

- Differing approaches to carbon pricing, including border adjustment measures such as those being implemented by the EU, will affect competition and could lead to additional trade tensions.

By contrast, as regards AI, both governments and businesses are trying to catch up to the possibilities and risks created by the products rapidly developed and disseminated by big tech firms. AI will be a disrupting force across the economy, and it is difficult to discern at this early stage the full scope and scale of the opportunities, risks, and impacts. U.S. big tech firms are in an intense race to lead the industry globally, while China is developing its own capacity. Canada has world-class AI talent, centers of excellence, and start-ups that under the right policy conditions can play a role in market development. Equally important is the innovative application of AI technology across all sectors of the economy. While the market signals are clear, policy frameworks globally and in Canada are less than fully developed, in particular to address the risks posed by the technology in such domains as privacy, cybersecurity, national security, and the rights of citizens.

- In March, the European Parliament passed the *Artificial Intelligence Act*, which aims to ensure "safety and compliance with fundamental rights, while boosting innovation."[10] The Act will operate together with other EU legislation in regulating the digital space.

- Last October, President Biden issued an *Executive Order on Safe, Secure, and Trustworthy Artificial Intelligence* aimed, *inter alia*, to establish standards for safety and security, protect privacy, advance equity and civil rights, and promote innovation and competition.[11] There is a patchwork of government agency rules that apply to specific aspects or uses of AI.

- In Canada, a bill comprising a proposed *Artificial Intelligence and Data Act* as well as a new *Consumer Privacy Protection Act* is still making its way through Parliament.

- While international discussions are ongoing in various forums, any internationally agreed standards are some ways off.

Thus, businesses that aim to invest in AI and to adapt business processes to leverage the technology must remain alert to the evolution of international laws and regulations and to how these changes will affect market development in the digital space.

In both the cases of energy and AI, a misalignment of policy and business signals can create considerable tension and pose a range of risks that have to be managed by businesses through the development of strategies and the execution of investments.

CONCLUDING OBSERVATIONS

The world is uncertain and fragmented. However, structural shifts and disruptions also create opportunities. To be on the winning side of change, businesses have to move forward with long-term strategies and investments.

On the positive side, and subject to the risks reviewed above, our economy is better positioned than many others because of our resource base and our proximity to a remarkably dynamic U.S. economy. Some large resource projects now coming into service (Trans Mountain Expansion) or advancing toward completion (LNG Canada) will secure early export revenue gains. Recent landmark investments in battery and EV manufacturing, supported by generous fiscal incentives, may help our automotive industry sustain or grow its participation in the North American EV supply chain. A ramp-up of investment and innovation across a wider range of sectors and the expansion and diversification of exports beyond the United States are required for long-term prosperity.

CHAPTER 3

Prospects for the U.S. and Canadian Economies to the End of 2026

After diverging during 2023, the economies of the United States and Canada are both projected to grow at about 2.0% on a fourth quarter to fourth quarter (Q4-to-Q4) basis through to 2026.

Factors affecting the two economies over this horizon include declining interest rates, less expansionary fiscal policies, and steady albeit subdued global growth.

In the United States, growth will slow to 2.0% during the remainder of 2024 from productivity-enhanced growth of 3.1% during 2023, whereas in Canada growth will pick up to 1.9% during 2024 from productivity-depressed growth of 1.0% during 2023.

We expect the U.S. economy to again rely on productivity improvement to achieve the projected 2.0% growth more heavily than in Canada where, as in the past, additional hours of work (i.e., more labour) are likely to play a more important role.

In our baseline scenario, inflation will decline gradually, reaching the 2% target in Canada by the end of 2025, and in the United States by early in 2026. The Bank of Canada has begun cutting its policy rate and the Federal Reserve is expected to follow in the second half of 2024. Rates will be reduced at different paces, but to the same floor of 3.0%, which will be reached early in 2026 in the two countries.

Our baseline scenario assumes that there will be no severe shocks from geopolitical or global trade developments. However, there is, and will be, considerable uncertainty in this regard and thus a wide dispersion of possible outcomes around our baseline scenario.

Additionally, a key risk to our projection for growth in Canada, whether on the upside or the downside, relates to how U.S. and Canadian inflation will evolve relative to expected profiles. Persistent deviations would trigger adjustments across the economy that would have repercussions on growth.

RECENT DEVELOPMENTS

1. Global Growth and Commodity Prices

The world economy has shown a surprising degree of resilience over the past quarters after a sharp increase in interest rates between early 2022 and the summer of 2023. In the advanced economies, robust gains in employment and wage rates, the withdrawal of substantial savings accumulated during the pandemic, and a more expansionary fiscal policy in the G-7 countries, notably the United States, provided counterweights to tighter monetary policy and other headwinds such as geoeconomic fragmentation.

Global growth, as proxied by growth in the G-20 countries,[1] averaged 3.2% during 2023 before accelerating to an annual rate of 3.9% in the first quarter of 2024 (Q1 2024) (Table 3.1). Although growth in Q1 2024 slowed markedly in the United States and turned negative in Japan, this was more than offset by an acceleration of growth in China, the euro area, the U.K., and Saudi Arabia, among other jurisdictions. At 3.9%, growth in the G-20 in Q1 was roughly equivalent to the average global growth of 3.8% over 2000–2019.

TABLE 3.1

Real GDP Growth (%) (s.a.a.r)

	Q2 2023	Q3 2023	Q4 2023	Q1 2024
World (proxied by G-20)	2.8	3.3	2.8	3.9 E
China	2.0	7.4	4.9	6.6
Euro area	0.6	-0.2	-0.2	1.3
United States	2.1	4.9	3.4	1.6

(s.a.a.r) Seasonally Adjusted Annual Rate
Source: OECD Data Explorer.

After a sharp fall between mid-2022 and mid-2023 that contributed to an easing of global inflationary pressures, commodity prices have leveled off or in some cases regained strength. West Texas Intermediate (WTI) oil prices, at close to US$80 per barrel in May, remain below the highs of over US$85 in June 2022 but markedly higher than the subsequent lows of US$65 in June 2023. Despite the war in Gaza and wider geopolitical tension, recent fluctuations in prices have been contained. Natural gas prices (Henry Hub spot) firmed up in Q3 and Q4 2023 after the sharp drop from the peaks of the summer of 2022, but again softened in Q1 2024 due to an unusually mild winter. They firmed up slightly in May, but at some US$2.20 per million BTU remain at historically low levels. Metals prices were stable in Q1 2024 after declining throughout 2023 in response to "subdued demand in major economies, including China, amid ample supply."[2] They rebounded sharply in April and May.

2. Growth in the United States and Canada

The U.S. economy was remarkably strong in the second half of 2023, growing at an annualized rate of 4.2%, while in Canada the economy contracted slightly by 0.1% (Table 3.2). The performance of the U.S. economy was much better than almost anyone expected because of strong private consumption and robust business investment, backed by high government spending and a buoyant labour market. In Canada, a stagnation of output was much expected; it materialized with a drop in non-residential business investment and weak growth in household consumption. Government spending made some contribution to growth, but much less so than in the United States. Despite stronger growth of aggregate demand in the United States than in Canada, there was no contribution of net exports to growth in Canada.

In Q1 2024, U.S. growth slowed to 1.3%, while in Canada it strengthened to 1.7%. In the United States, personal consumption, housing, and non-residential business investment together grew at nearly the same buoyant rate as during the second half of 2023, but much of that demand growth was met by an expansion of imports and a fall in inventories. Government spending (consumption and investment) slowed abruptly, while exports were nearly flat. In Canada, final domestic demand grew robustly in Q1 2024, mostly on the strength of household consumption, with also a rebound of non-residential business investment and government consumption. Most of the increase in demand was met by a fall in inventory investment. Again, net exports made no meaningful contribution to growth.

3. The Labour Market

In both the United States and Canada, after a period of exceptional tightness in 2022, the labour market has eased—in the United States with some interruption between mid-2023 and March 2024 because of strong economic growth, and in Canada more steadily through the period (Table 3.3). The easing of the labour market continued in Canada between December and April, despite the economic rebound, because of strong growth in the labour force (3.7% at an annual rate), which was driven by a large increase in the working-age population (3.8%), itself explained by high levels of immigration (including temporary foreign workers). Robust employment growth, at a 2.5% annual rate, limited the rise in the unemployment rate to 6.1% in April from 5.8% in December. Job vacancies continued to fall, and this too contributed to widening the gap between labour supply and demand.

In both the United States and Canada, average hourly earnings growth, on a year-over-year basis, has been slowly declining in 2024, dropping to 3.9% and 4.7%, respectively, by April. Measured on a fixed-weight basis (i.e., as if the structure of employment by occupation had not changed since 2019), the year-over-year hourly earnings growth in Canada in April was much lower (3.1%), and the fall over

TABLE 3.2

Contributions to Annualized Real GDP Growth (%)

	Average of Q3 and Q4 2023		Q1 2024	
	United States	Canada	United States	Canada
Real GDP growth	4.2	-0.1	1.3	1.7
Contributions from:				
Personal Consumption	2.2	0.9	1.3	1.6
Housing	0.2	0.3	0.6	0.1
Non-residential business investment	0.4	-1.5	0.4	0.5
Government consumption and investment	0.9	0.3	0.2	0.5
Net exports	0.1	-0.1	-0.9	0.1
Change in inventories	0.4	0.0	-0.5	-1.5

Sources: U.S. Bureau of Economic Analysis and Statistics Canada table 36-10-0104-01.

TABLE 3.3

Labour Market Tightness and Wage Inflation in the United States and Canada

	Q4 2023	Jan. 2024	Feb. 2024	Mar. 2024	Apr. 2024
United States					
Job vacancies per unemployed	1.43	1.43	1.43	1.25	
Average hourly earnings - y/y% s.a.	4.3	4.4	4.3	4.1	3.9
Canada					
Job vacancies per unemployed	0.53	0.52	0.52	0.46	
LFS average hourly earnings - y/y% not s.a.	5.0	5.3	5.0	5.1	4.7
LFS fixed-weight average hourly earnings - y/y%	4.3	4.1	3.7	3.7	3.1

Sources: U.S. Bureau of Labor Statistics, and Statistics Canada tables 14-10-0406-01, 14-10-0287-01, and14-10-0426-01. The fixed-weight measure of average hourly earnings for Canada is produced by Bennett Jones using Statistics Canada data. LFS refers to Labour Force Survey data.

the past year more rapid, than if measured on a current-weight basis (i.e., if account is taken of changes in the structure of employment, for example from lower-wage to higher-wage occupations). We are inclined to think that average hourly earnings evolve on a *trend* between the current-weight and the fixed-weight measures, thus at rates of around 4.5% in Q1 2024 and 4.0% in April.

4. Inflation

The core inflation measures closely watched by the Federal Reserve and the Bank of Canada exhibited clear downward trends during 2023. Whereas in the United States there has been no further noticeable progress this year to April, in Canada core inflation has continued to ease markedly. The key annual inflation measure watched by the Federal Reserve, the Personal Consumption Expenditures Price Index excluding Food and Energy (PCEXFE), was 2.8% in April vs 2.9% in December (Table 3.4). Meanwhile, the average of key inflation measures watched by the Bank of Canada (Consumer Price Index [CPI]-median and CPI-trim) was 2.8% in April vs 3.6% in December. By April, in the United States 12-month headline CPI inflation was as high as in December, whereas in Canada it was markedly lower even as gasoline prices were significantly higher than a year before.

Monthly core inflation numbers in the first four months of 2024 tell the same story: inflation appears to be more persistent in the United States than in Canada. In the United States, average monthly core inflation was 4.1% at an annual rate in the four months to April 2024 compared with 2.2% for September to December 2023. In Canada, it diminished to 1.4% in the four months to April from 3.2% in the previous four months. In the single month of April, core inflation eased in the United States to 3.0% at an annual rate. In Canada, it increased relative to prior months but to a still modest rate of 1.7%.

TABLE 3.4

Consumer Price Inflation in the United States and Canada

12-Month %		Sep. 23	Dec. 23	Jan. 24	Mar. 24	Apr. 24
United States	CPI - all items	3.7	3.4	3.1	3.5	3.4
	Core inflation: PCEXFE	3.6	2.9	2.9	2.8	2.8
Canada	CPI - all items	3.8	3.4	2.9	2.9	2.7
	Average of CPI-median and CPI-trim	3.7	3.6	3.3	3.1	2.8

S.A.A.R. %		Sep.–Dec. 23	Jan.–Apr. 24	Apr. 24
United States	Core inflation: PCEXFE	2.2	4.1	3.0
Canada	Average of CPI-median and CPI-trim	3.2	1.4	1.7

PCEXFE: Chain-type price index for personal consumption expenditures excluding food and energy

Sources: U.S. Bureau of Labor Statistics; and Statistics Canada tables 18-10-0004-01, 18-10-0006-01 and 18-10-0256-01.

5. Interest Rates and Exchange Rates

From July 2023 to May 2024, the Federal Reserve kept its target range for the Fed funds rate at 5.25–5.5%, and the Bank of Canada kept its policy rate at 5.0%. In June, the Bank of Canada lowered its policy rate, by a quarter point.

Changes in long-term rates in both the United States and Canada through the period have reflected changing market expectations about *future* policy rates. In May, 10-year government bond rates averaged 4.5% in the United States and 3.6% in Canada, about where they were last November (Table 3.5). There was a drop in long-term rates in December because of a shift in market expectations toward earlier cuts in U.S. policy rates. As this sentiment faded with new inflation data and signals from the Fed, rates rose back progressively.

The Canadian dollar slightly lost ground relative to the U.S. dollar this year, mostly in April when the U.S. dollar appreciated 1.2% on a multilateral basis. This appreciation was in reaction to developments in the U.S. economy suggesting that inflation was more persistent, thus that U.S. interest rates might have to stay high for longer than in some other economies, and that correspondingly interest rate differentials might become even more favourable to the U.S. dollar. Over the months of April and May, the Canadian dollar averaged US$0.731.

6. Fiscal Policy

With larger deficits, fiscal policy has been far more supportive of economic activity in the United States than in Canada over the last year. However, the *impulse* to GDP growth from *changes* in net borrowing by general government turned from positive to negative in United States in the last two quarters, whereas in Canada it has stayed positive. General government (federal, state, or province, and local) net borrowing as a percentage of GDP was much greater in the United States than in Canada in 2023—for example, 9.3% of GDP in Q3 in the United States vs. 1.0% in Canada (Table 3.6). However, since net borrowing contracted in the United States in both Q4 2023 and Q1 2024, the impulse to GDP growth turned negative. In Canada, net borrowing as a percentage of GDP increased in Q4 2023 and Q1 2024, but much less so than in Q3 2023. The cumulative impulse to growth in the last two quarters

TABLE 3.5

Key Financial Rates for the United States and Canada in 2024

	February	March	April	May
Effective Fed funds rate	5.3	5.3	5.3	5.3
Canadian overnight rate - %	5.0	5.0	5.0	5.0
U.S. 10-year Treasury yield - %	4.2	4.2	4.5	4.5
10-year Canada bond yield - %	3.5	3.4	3.7	3.6
U.S. dollar per Canadian dollar	0.741	0.739	0.731	0.731
Appreciation of broad US$ index (%)	0.7	-0.3	1.2	-0.2

was 0.6% of GDP, about the same as in Q2 and Q3 2023. The patterns of government spending also differed across the two economies. In the United States, growth in government consumption of goods and services and gross investment were buoyant during 2023, but modest in Q1 2024 (1.3% at an annualized rate). In Canada, it rebounded to 2.1% in Q1 2024 from -1.6% in the preceding quarter.

A BASELINE SCENARIO

1. Assumptions for Global Factors

Global factors described in Chapter 1, including geopolitical and trade tensions, cost pressures, a trendline of low productivity growth, and structural change pose considerable uncertainty for the short- and medium-term economic outlook.

For business planning, the best approach is to set out a baseline scenario while recognizing uncertainty and risk, and the fact that there is a wide distribution of possible outcomes for growth, inflation, and other variables around this scenario.

In our baseline scenario, as in most forecasts, we assume away shocks from such factors whose probability, size, and effects are extremely difficult to evaluate. The following assumptions underpin our baseline scenario.

- There are no further, unexpected repercussions from the wars in Ukraine and the Middle East.
- Recent trade tensions and protectionist actions do not result in further, severe restrictions and disruption of global trade flows.
- The WTI oil price moves in a range of US$75 to US$85 per barrel, and commodity prices are broadly stable.

TABLE 3.6

Impluse to Growth from General Government

		Q2 2023	Q3 2023	Q4 2023	Q1 2024
United States	Net government borrowing as % of GDP	7.7	9.3	7.6	7.5
	Impulse to growth: change in net borrowing (p.p. of GDP)	0.5	1.6	-1.7	-0.1
	Growth in real GC and GI (% a.r.)	3.3	5.8	4.6	1.3
Canada	Net government borrowing as % of GDP	-0.6	1.0	1.4	1.6
	Impulse to growth: change in net borrowing (p.p. of GDP)	-1.1	1.6	0.4	0.2
	Growth in real GC and GI (% a.r.)	0.0	4.3	-1.6	2.1

GC: government consumption of goods and services. GI: government gross fixed capital formation

Sources: U.S. Bureau of Economic Analysis and Statistics Canada tables 36-10-0118-01 and 36-10-0104-01.

Our scenario for the United States and Canada to 2026 is set against the backdrop of projected steady growth in the rest of the world at the same 3.4% pace as in 2023 (Table 3.7). This is fully consistent with the latest outlooks put out by the IMF and the Organisation for Economic Co-operation and Development (OECD). Growth in advanced economies other than the United States and Canada will remain subdued in 2024 on an average annual basis, before climbing to 1.7% over the next two years, mostly reflecting higher growth in Japan and the euro area. The projected recovery in the euro area is buttressed by rising real incomes resulting from lower price inflation and robust wage growth. Most importantly, monetary policy in the euro area is exerting less drag as the effect of the earlier tightening is fading and as the positive impact of cuts in the policy rate starting in mid-2024 begin to take hold.

Based on the latest IMF outlook, annual growth in emerging and developing economies (EDEs) is projected to be flat at 4.2% through to 2026: growth in China will slow from 5.0% in 2024 to 3.9% in 2026; in other EDEs, it will rise modestly from 3.9% in 2024 to 4.3% in 2026. China faces several structural headwinds to activity, including persistent weakness in the property market that is weighing on financial markets and consumer sentiment; an ongoing decline in the working-age population; and the absence of social security reform, keeping household saving rates very high and thus continuing to constrain consumption. In fact, government policies in China continue to favour saving over household spending. Given weakness in the residential property market, this means that industrial investment and growing exports will continue to be the principal engine of demand growth.

In China, high real interest rates may act as a further drag on growth while also exacerbating fiscal strains. Real borrowing costs for firms and households have risen considerably as inflation has fallen faster than nominal interest rates. Unless monetary policy eases, which the authorities recently announced their intention to do, these tighter financing conditions will depress activity. Meanwhile, Chinese governments will continue to run large

TABLE 3.7

Short-Term Prospects for Real GDP Growth Outside North America
(%, average annual basis)

	2023	2024	2025	2026
World	3.2	3.1	3.2	3.2
World excluding the United States and Canada	3.4	3.3	3.5	3.4
Advanced Economies excluding the United States and Canada	1.1	1.0	1.7	1.7
Euro area	0.5	0.7	1.5	1.5
Japan	1.9	0.2	1.2	0.7
Emerging and Developing Economies	4.3	4.2	4.2	4.2
China	5.2	5.0	4.4	3.9

primary deficits in the years to come, with fiscal strains particularly acute at the local level. The IMF expects that while the growth rate of the economy will be higher than the interest rate paid by governments on their debt, such primary deficits will continue to push the public debt-to-GDP ratio higher in the years to come. In all likelihood, this will put upward pressure on domestic financing costs and accentuate weakness in the domestic banking system, creating added vulnerability for the economy.

2. Fiscal Policy

Regardless of the outcome of the November election in the United States, unease over mounting deficits is likely to lead to some action over the next three years toward a less expansionary United States fiscal policy, and therefore less support to activity going forward. The IMF projects that the general government primary balance as a percentage of GDP will diminish from 5.8% in 2023 to an average of 3.4% from 2024 to 2026.[3]

For Canada, we draw the following conclusions from an analysis of the most recent budgets tabled by the federal government and the four largest provinces (Box 3.1).

- **Fiscal policy will provide a modest stimulus to growth in 2024, and slow down growth in 2026.**
- **Given projected deficits, debt, and interest costs, governments will have no difficulty borrowing to meet their financial requirements, but the budgets represent a missed opportunity to build a fiscal buffer to use in the medium term when faced with a shock.**
- **The real program spending per capita that is implied by the budgets remains below the levels that would match the services governments have promised.**
- **There is no evidence in the budgets of changes to the structure of spending and revenue that would contribute to a stronger trendline of GDP per capita growth.**

BOX 3.1

KEY IMPLICATIONS OF THE MOST RECENT BUDGETS IN CANADA

We judge that the most recent budgets tabled by the federal government and the governments of Ontario, Québec, Alberta, and British Columbia will deliver a modest stimulus to real GDP growth in 2024, likely no more than 0.5 percentage points, and slow down growth in 2026 by a similarly modest amount (Table 3.8). This would tend to slow slightly the pace of disinflation in Canada in 2024 and to have the contrary effect in 2026. This is based on net borrowing by the governments increasing relative to GDP by 0.8 percentage points in 2024 and then declining in 2025 and 2026 by 0.4 and 0.8 percentage points, respectively. The budget deficits projected by the governments for 2024–2025 rest on more conservative assumptions about growth in Canada than we and many others now carry in our outlooks. Fiscal revenues may turn out stronger, and deficits smaller, than projected in the budgets for this fiscal year. Consequently, the stimulus to growth and inflation may well be smaller than implied by the budget projections.

The projected debt, deficits, and interest costs of federal and provincial governments are high, but they can be managed over the next two years given the economic growth projected in the budgets. This said, **governments missed the opportunity afforded by reasonable economic growth to build a fiscal buffer for use in the event of a severe shock to the economy.** In all provinces but Alberta, the fiscal deficit in 2024–2025 is close to, or above, 1.0% of GDP; it is highest in British Columbia at 1.9%. The deficits fall gradually in the subsequent two fiscal years, with only British Columbia staying above 1.0% of GDP by 2026–2027. Alberta will realize a small surplus in 2024–2025 that will grow in 2025–2026 and 2026–2027. The ratio of interest costs to revenues, which in the federal budget will peak at 10.9% in 2024–2025, will decline gradually in all jurisdictions over the next two fiscal years as the debt-to-GDP ratio stabilizes or declines modestly and as interest rates move down. The exception again is British Columbia, where provincial debt will rise markedly as a percentage of provincial GDP and where interest costs will absorb a rising share of revenue.

In our judgment, the real program spending per capita that is implied by the budgets remains too low to deliver the services governments have promised. Between 2023–2024 and 2026–2027, real program spending per capita declines significantly in each of the large provinces, notwithstanding the promises they are making to improve health and education services. It increases in the federal budget, but quite modestly considering pressures and promises to grow spending in domains such as national security, or pharmacare or disability benefits, beyond expenditures booked in the fiscal framework.

The structure of spending and taxes embedded in the budgets is unlikely to contribute to the stronger growth in GDP per capita that would enable governments to meet their promises without incurring larger deficits or raising new taxes. Chapter 1 described Canada's challenge in closing gaps in productivity to restore stronger growth in GDP per capita and to improve standards of living. This requires stronger investment in the productive capacity of the economy. For government, such investment is appropriate to finance by borrowing because it will generate a future stream of revenue that can support long-term economic growth and fiscal sustainability. However, the accumulation of borrowing to pay for current services to Canadians erodes over time the capacity of the economy to generate wealth. Similarly, a tax structure that strengthens incentives to save and to invest in productive assets will make a better contribution to growth in GDP per capita than one that stimulates consumption. **There is no evidence in the federal and provincial budgets of shifts in the structure of expenditures and taxes that recognize the priority to be accorded to raising productivity growth and improving the trendline of GDP per capita.** Only such efforts would generate the resources for governments over time to meet rising expenditure commitments and expectations.

TABLE 3.8

2024 Budgets: Canada, Ontario, Québec, Alberta and British Columbia						
		2023–2024	2024–2025	2025–2026	2026–2027	Average 2024–2026
Canada	Deficit (% of Canadian GDP)	1.4	1.3	1.2	0.9	
April 16, 2024	Primary surplus (% of Canadian GDP)	0.2	0.5	0.5	0.8	
	Federal debt (% of Canadian GDP)	42.1	41.9	41.5	40.8	
	Real program spending per capita - % growth*	-3.8	2.7	0.0	-0.6	0.6
	Interest costs (% of revenues)	10.1	10.9	10.7	10.6	
	Revenues to GDP - %	16.1	16.6	16.5	16.5	
Ontario	Deficit (% of Ontario GDP)	0.3	0.9	0.4	0.0	
March 26, 2024	Primary surplus (% of Ontario GDP)	0.9	0.4	0.9	1.3	
	Net debt (% of Ontario GDP)	38.0	39.2	39.5	39.1	
	Real program spending per capita - % growth*	-2.3	-0.8	-0.7	-1.8	-1.1
	Interest costs (% of revenues)	6.3	6.8	6.8	6.7	
	Own-source revenues to GDP - %	15.5	15.1	15.4	15.5	
Québec	Deficit (% of Québec GDP)	0.7	1.5	1.0	0.3	
March 12, 2024	Primary surplus (% of Québec GDP)	1.0	0.2	0.5	1.3	
	Net debt (% of Québec GDP) - March	39.0	40.3	41.0	40.6	
	Real program spending per capita - % growth*	-2.9	0.6	-0.2	-1.3	-0.3
	Interest costs (% of revenues)	6.6	6.5	6.1	6.2	
	Own-source revenues to GDP - %	20.4	20.5	20.6	20.8	
Alberta	Surplus (% of Alberta GDP)	1.2	0.1	0.3	0.5	
February 29, 2024	Primary surplus (% of Alberta GDP)	1.9	0.8	0.9	1.1	
	Net debt (% of Alberta GDP) - March	9.3	9.1	8.5	7.7	
	Real program spending per capita - % growth*	1.3	-3.9	1.6	-1.6	-1.3
	Interest costs (% of revenues)	4.1	4.6	4.1	4.0	
	Own-source revenues to GDP - %	14.3	13.4	13.0	12.8	
British Columbia	Deficit (% of B.C. GDP)	1.4	1.9	1.8	1.4	
February 22, 2024	Primary surplus (% of B.C. GDP)	-0.6	-0.9	-0.7	-0.1	
	Taxpayer-supported debt (% of B.C. GDP)	17.6	21.0	24.8	27.5	
	Real program spending per capita - % growth*	-4.2	2.8	-2.7	-1.9	-0.7
	Interest costs (% of revenues)	4.3	5.0	5.8	6.6	
	Own-source revenues to GDP - %	15.5	15.9	15.4	15.6	
Total deficit as % of Canadian GDP		1.7	2.2	1.8	1.1	
Net capital investment as % of Canadian GDP		1.2	1.4	1.4	1.3	
Change in net borrowing (% of Canadian GDP)**			0.8	-0.4	-0.8	
Impact on Canadian real GDP growth (p.p.)***			0.5	-0.1	-0.5	

* Growth in program spending per capita less growth in government consumption deflator for Canada.
** Net borrowing is the sum of deficit and net capital investment.
*** Assuming fiscal multipliers of 0.65 for change in deficit and 1.0 for change in net capital investment, spread as 80% first year and 20% second year.

3. Real GDP Growth in the United States

On a Q4-to-Q4 basis, U.S. growth is projected to diminish to 1.9% in 2024 from 3.1% in 2023 and to remain around 2.0% in 2025 and 2026 (Table 3.9). On an annual basis, real GDP growth would be 2.5% in 2024 and settle around 2.0% over the next two years. This baseline scenario is much in line with projections made by the IMF in April, the Federal Reserve in March, and the OECD in May, although with slightly weaker growth for 2024.

U.S. growth will slow during 2024 as fiscal policy becomes less expansionary, a softening labour market slows aggregate demand, and the appreciation of the U.S. dollar in the last year stimulates net imports. Moreover, little of the savings accumulated during the pandemic remain to fund consumption and U.S. households' credit limits are likely to become more binding. Some of the above factors will continue to moderate growth in 2025, but they will be partly offset by the effects of a loosening of monetary policy starting in late 2024. Lower interest rates will buttress growth in 2025 and 2026 to about 2.0%, which will be in the vicinity of potential output growth.

4. Real GDP Growth in Canada

In Canada, on a Q4-to-Q4 basis, growth accelerates from 1.0% in 2023 to 1.9% in 2024 (Table 3.10). Growth will peak during the first half of 2025, when at an annualized rate it will average 2.3%. The economy will then grow at a rate of 1.9% to the end of 2026. On an annual basis, real GDP growth would be 1.2% in 2024, 2.2% in 2025, and 1.9% in 2026. This scenario for Canada closely matches the projection in the Monetary Policy Report of the Bank of Canada in April, albeit with slightly weaker growth for 2024.[4]

Stronger growth in the first half of 2024 is underpinned by an exceptionally large increase in population itself due to a surge in the number of non-permanent foreign workers. Several other factors will contribute to keeping Canadian growth on par going forward. These include:

- the fading effect of past increases in interest rates, an easing of monetary policy starting mid-2024, and a diminishing drag from debt-servicing costs for households and businesses;
- U.S. growth at about its potential rate through to the end of 2026;
- modest fiscal stimulus in 2024, although it gets reversed in 2026;
- an improvement in confidence that supports spending; and
- the operation of the newly commissioned Trans Mountain Expansion pipeline, which significantly raises oil export capacity.

TABLE 3.9

U.S. Real GDP Growth

	2023	2024	2025	2026
Q4/Q4 % change	3.1	1.9	1.9	2.0
Year-on-year growth - %	2.5	2.5	1.9	2.0

TABLE 3.10

Canadian Real GDP Growth

	2023	2024	2025	2026
Q4/Q4 % change	1.0	1.9	2.1	1.9
Year-on-year growth - %	1.2	1.2	2.2	1.9

Supported by falling interest rates, household consumption growth is expected to accelerate over the scenario horizon, even though population is projected to grow more slowly than in 2023 and in the first half of 2024.

Housing investment will rebound in 2024 and exhibit strong growth in 2025 and 2026, buttressed by new government policies to increase new construction and by lower financing costs for renovation projects.

Business non-residential investment is projected to revive as prospects for aggregate demand improve and as financial conditions ease. At the same time, borrowing and investment may be dampened by a factor referenced in Chapter 4, namely the decision by the Office of the Superintendent of Financial Institutions to require implementation of Basel IV requirements by Canadian banks by mid-2026, ahead of some global competitors. This regulatory decision has the potential to reduce materially bank lending to firms and households, thereby holding back private investment in housing and business fixed investment. This effect is not taken into account in our baseline scenario.

5. CPI Inflation in Canada

In our baseline scenario, Canadian headline CPI inflation declines from 2.8% in Q1 2024 to 2.5% by Q4 2024 and to 2.1% by Q4 2025, with no change through 2026 (Chart 3.1). We expect somewhat less reduction in headline inflation during 2024 than in the Bank of Canada's latest Monetary Policy Report, but we end up with the same levels of inflation as projected by the Bank at the end of 2025 and 2026. In our scenario, goods inflation gradually rises from 1.2% in Q1 2024 to 1.7% by Q4 2026, while services inflation gradually declines from 4.3% in Q1 2024 to 2.4% by Q4 2026.

We expect a number of factors to contribute to lower core and services inflation.

- Excess supply in the economy, which the Bank of Canada expects at around 1.0% of GDP in the first half of 2024, will decline over time but still exert downward pressure on inflation, at least to mid-2025.

- Wage rate inflation is expected to moderate with less tightness prevailing in labour markets and with declining headline inflation helping to contain wage demands; lower wage inflation in turn will support disinflation in services industries.

- Corporate pricing will normalize.

- Mortgage interest costs will make a diminishing contribution to services inflation after policy interest rates start declining mid-2024.

Housing rental markets, however, are expected to remain tight due to continued population pressures, thereby keeping rent inflation high and persistent.

6. Prospects for Monetary Policy

We judge that the Bank of Canada should make one or two further quarter point cuts by the end of 2024. We think the Federal Reserve is likely to cut once by a quarter point, by year-end (Table 3.11). While inflation has been sticky in the United States to date this year, we discount the possibility of the Fed raising rates. Thus, by December 2024 rate cuts would bring the overnight rate in Canada to 4.5% (or 4.25%) and the target fed funds rate (lower bound) to 5.25%.

Policy rates in both countries would further decline to 3.0% before the end of 2026. In our view, this 3.0% level should be in the vicinity of the neutral rate that would balance aggregate demand and potential output in a world more supply-constrained than in the pre-COVID period.

We see long-term interest rates remaining somewhat below 4.0% in Canada until the end of 2026, and in the United States trending down to the same level over the period. The Canadian dollar should evolve within a US$0.72 to US$0.78 range, but with a tendency to strengthen over time as U.S. interest rates converge on the lower Canadian rates.

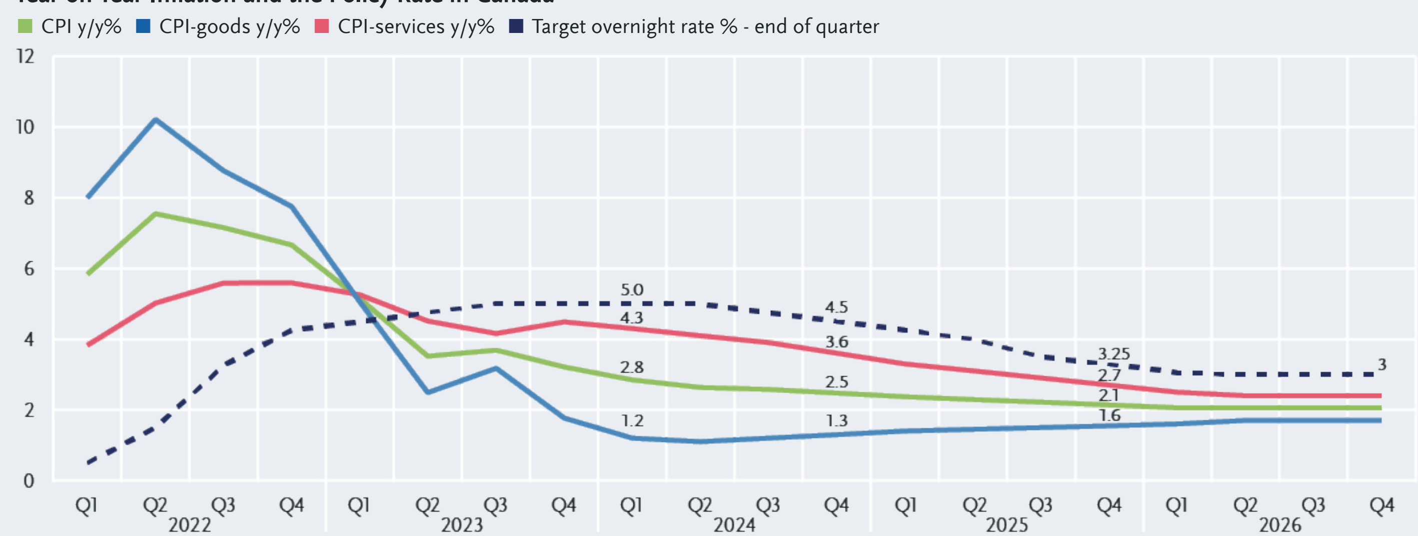
TABLE 3.11

U.S. and Canadian Interest Rates in the Short Term

December	2023	2024	2025	2026
Fed funds rate (upper limit)	5.5	5.25	3.5	3.0
Canadian overnight rate - %	5.0	4.5 (4.25)	3.25	3.0
U.S. 10-year Treasury yield - %	4.0	4.5	4.1	3.5
10-year Canada bond yield - %	3.8	3.8	3.8	3.5
U.S. dollar per Canadian dollar	0.73	0.72-0.74	0.73-0.76	0.73-0.78

CHART 3.1

Year-on-Year Inflation and the Policy Rate in Canada



7. Risks to Growth in Canada

There continues to be much uncertainty about future geopolitical and global trade developments and their consequences for the world and Canadian economies.

Abstracting from possible external shocks from these factors, and setting aside also the potential impacts of the U.S. election in November, we highlight three key factors that could affect, positively or negatively, Canadian growth to 2026.

- **U.S. Inflation:** If inflation in the United States remains sticky, or worse still if it regains strength, the Federal Reserve may delay cutting its policy rate or even start increasing it again. This would tighten financial conditions and reduce U.S. growth, with negative consequences for Canada. Conversely, if U.S. inflation were to decline more rapidly than expected, and the policy rate were to be cut earlier and faster, this would have a positive effect on Canadian growth.
- **Canadian Inflation:** Similarly, inflation in Canada may decline more rapidly than we expect, in which case financial conditions would ease earlier, real income and confidence would strengthen more quickly, and Canadian growth would be enhanced. On the other hand, core or services inflation could prove stickier than we project following recent progress, the Bank of Canada would have to hold off on further rate cuts, and this would have negative consequences for Canadian growth.
- **Canadian Productivity Growth:** Our scenario assumes a resumption of modest growth of labour productivity in Canada over the period to 2026. If labour productivity growth instead were to be persistently nil or even negative, the non-inflationary pace of growth in Canada would be lower, inflationary pressures likely greater, interest rates higher, real wages lower, and growth slower. A positive surprise on labour productivity growth would have the opposite effects on growth.

PROPOSED PLANNING PARAMETERS

While uncertainties abound, we consider that our scenario for the U.S. and Canadian economies to the end of 2026 constitutes a reasonable basis for planning. This scenario implies growth during the period at rates of about 2.0% in both countries (Table 3.12). Headline inflation declines to target by the end of 2025 in Canada and a little later in the United States, given much slower progress in U.S. disinflation during 2024. Correspondingly, policy rates decline more slowly in the United States at first but end up at the same level of 3.0% as in Canada by 2026. Leaving aside possible geopolitical or trade shocks, which are quite plausible but impossible to predict, we judge the upside and downside risks to the scenario to be roughly balanced. In an uncertain and fragmented world, businesses must in all cases maintain the flexibility to adjust their plans.

TABLE 3.12

Planning Parameters

	United States	Canada
GDP growth (Q4/Q4 % change)		
2023	3.1	1.0
2024	1.9	1.9
2025	1.9	2.1
2026	2.0	1.9
Headline CPI (Q4/Q4 % change)		
2023	3.2	3.2
2024	3.0	2.5
2025	2.3	2.1
2026	2.1	2.1
Policy rate (%)		
Dec-23	5.5	5.0
Dec-24	5.25	4.5 (4.25)
Dec-25	3.5	3.25
Dec-26	3.0	3.0
10-year Treasury yield (%)		
Q4 2023	4.0	3.8
Q4 2024	4.5	3.8
Q4 2025	4.1	3.8
Q4 2026	3.5	3.5
WTI oil price (US$ per barrel)		
2023	78	
2024	75-85	
2025	75-85	
2026	75-85	
Canadian dollar (US cents)		
2023	0.73	
2024	0.72-0.74	
2025	0.73-0.76	
2026	0.73-0.78	

CHAPTER 4

Policy Directions to Raise Productivity Growth

The improvement of the standards of living of Canadians over time depends on re-establishing a trend of stronger growth in GDP per capita. Because the share of the working-age population will decline over the medium term, productivity—output per worker—must grow faster.

In the aggregate, improvements in the productivity of the economy will result from business enterprises investing more per worker and innovating in the use of capital, technology, and labour.

At the level of individual firms, the decisions to invest and to innovate require judgments about the business environment as it may be shaped over the medium term by global developments, technology, market factors, and government policy and regulation.

Business enterprises have to make calculated bets in the pursuit of what they assess to be the opportunities to realize the best risk-adjusted returns. Investment in physical and human capital is a necessary although not sufficient condition of success. In an economy largely founded on intangible assets, innovation and the development and commercialization of intellectual property are instrumental.

Firms that are able to see beyond the next quarterly earnings cycle, execute on a strategy, and capitalize on shifts in the economy will succeed. Others, by standing still or by making the wrong bets, will not.

It is the result of these judgments and decisions made by thousands of individual enterprises in the pursuit of opportunity, together with the reallocation of resources in the economy to the most successful firms, that produce the aggregate increase (or lack thereof) in productivity and GDP per capita. Economists refer to this process as one of "creative destruction." In a fast-paced world, growth also means disruption—and therefore adjustment.

The role of government in this process is to establish a policy framework—an incentive structure—that facilitates the decisions of enterprises to invest and the access to saving that can fund that investment. Policy can also facilitate the adjustment, including the skilling and reskilling of workers. While policy cannot directly generate growth or improvement in living standards, it can create favourable conditions for private (and public) enterprises to raise output per worker through investment and innovation. In aggregate and over the medium term, this should result in a higher share of GDP allocated to investment, and a reduced share to current consumption.

Given a need to also raise saving and investment to build more homes over the coming years, a policy framework that aims to accelerate growth in GDP per capita will involve difficult policy trade-offs. In the short term, investing in a better future means not austerity, but focus and discipline.

A detailed economic policy agenda is beyond the scope of this report. We set out below key attributes of a policy framework and review some domains of priority attention for the federal and provincial governments.

A STRATEGY TO RAISE PRODUCTIVITY GROWTH: "PLANS BEATS NO PLAN"[1]

For government, the pursuit of stronger growth in investment, productivity, and GDP per capita starts with the articulation of a strategy—the policy framework—that gives direction, predictability, consistency and coherence to its actions, comprising:

- **the universe of policy, program, and regulatory initiatives that act upon the incentives to work, save and invest;**
- **fiscal management, including the structure of spending and revenue, and the fiscal balance, which affect aggregate saving and investment in the economy; and**
- **the efficiency of delivery of government that determines the productivity of the public sector and that also bears on the productivity of the recipients of the services.**

There is no lack of federal and provincial policy and programs to support workers and firms in building a stronger economy; every budget brings a new instalment. What is less evident is a *strategy* that situates productivity growth as an overriding objective of policy and that connects all of the initiatives in a coherent whole that serves this priority.

A strategy that is laser-focused on productivity growth must have a medium-term horizon. It is a lengthier and more difficult enterprise to raise the real incomes of Canadians by facilitating saving and investment than to deliver new benefits through programs or transfer payments funded by borrowed money. It is worth repeating that one cannot redistribute what one doesn't produce. The channels by which real and sustainable gains in GDP per capita can be realized are indirect. There must be clear and consistent signals to investors over time and across policy and programs, such that, for example, an investment intended to be stimulated by a tax credit is not frustrated by a regulatory roadblock. Investments in energy and resource infrastructure, as well as in R&D and innovation, need visibility beyond any political cycle. Details of the policy framework will evolve, in particular to respond to global developments. But there must be medium-term principles and policy anchors.

Fiscal management must establish a credible trendline of expenditures and revenues and ensure that, over the economic cycle, new borrowing is used only to fund investments that grow the productive capacity of the economy. The fiscal situation of governments in Canada (e.g., deficit- or debt-to-GDP ratios) compares favourably with that of other major developed economies. Indeed, this is an advantage to build upon. Yet, **there are two key preoccupations**.

- **First, as described in Chapter 3, the current expenditure projections of governments are not consistent with the promises and expectations of rising levels of services.** For example, the federal government has introduced the first instalments of a pharmacare program and a disability benefit without building the large costs of mature programs into its fiscal plan. Meanwhile, projected increases in defence spending may be less than what is required to meet our global responsibilities. Similarly, provinces appear to understate ongoing spending pressures, notably in health care: they are budgeting declining spending per capita. Something will have to give. **Keeping deficits on the current projected tracks will require either reconsideration of service commitments or broad-based tax increases.**
- **Second, deficits today are incurred, and public debt is accumulated, largely to support current services to Canadians.** It is appropriate for governments to borrow to fund public investment that will support a growing economy and generate future revenue. It is also appropriate for them to borrow to support the economy in the downside of the business cycle when private demand is deficient. However, over the cycle current services should be paid by current taxes. There is no demonstration, in either accounting or policy terms, that governments are in fact exerting this discipline.

A productivity focus by government also entails more attention to execution and delivery. Federal, provincial, and local governments together represent over 40% of GDP, and the delivery of their services affects the performance of firms and workers. Federally, the multiplication of policy priorities and programs, pre-, during, and post-COVID, has tested capacity to deliver. The old adage "underpromise and overdeliver" has been all too frequently ignored. A 40% growth in the size of the public service between 2015 and 2023 has exceeded onboarding capacity. While productivity is difficult to measure in the public sector at the best of times, it likely diminished during this period. There have been spectacular administrative failures that, while affecting a small proportion of total government activity, have resonated beyond government, causing damage to the reputation of the public service. Provincial and local governments also struggle across the country to deliver health care and other public services that Canadians wish—rightly so—to be among the best in the world. In government as in the private sector, the efficient delivery of services requires more investment in people, technology, and data, including AI.

There is a role for every level of government in creating the policy framework to raise Canada's productivity growth, and there should be both collaboration and accountability. The federal government has powerful levers, and it can exert national leadership. Yet, provinces and territories, as well as local governments, and in some cases Indigenous governments, are on the front lines of policy development and especially delivery in key domains, including public infrastructure, worker skilling and reskilling, housing, and of course health care and education. Jurisdictions are generally not airtight, and there must be intergovernmental cooperation. But this should not blur accountability for results. Where there is use of the federal spending power, there should be alignment on objectives, goals, and efficient delivery. On all matters of regulation, citizens and businesses deserve the highest levels of collaboration and efficiency.

NATIONAL PRIORITIES

In our *2024 Economic Outlook*, we cited five domains of priority attention for government.

- **Immigration**—adjusting policy and programs so that economic immigration serves less as a stopgap for immediate worker shortages and more as a source of highly skilled, productive workers.
- **Competition**—intensifying incentives to invest and innovate by ensuring that trade, investment and marketplace frameworks keep markets open and contestable.
- **Tax Structure**—strengthening incentives to work, save, and invest by placing greater reliance on consumption taxes to raise the revenue to meet current and future spending commitments.
- **Business Frameworks for the Data Economy**—moving faster in adapting laws, regulations, standards, and codes to stimulate innovation while safeguarding consumer confidence and trust, privacy, and cybersecurity.
- **Environmental Regulation**—streamlining project reviews and permitting such that, together with competitive fiscal instruments, it supports the building of projects and facilitates the energy transition.

Each of these priorities remains salient. On immigration, we note recent federal efforts to contain the inflow of temporary workers and foreign students, as well as maximum working hours for foreign students. The programs have grown to unsustainable levels, and, as a source of workers in often low-skilled occupations, their impact on productivity and wages has been mixed at best. Amendments to the *Competition Act* (Bill C-56) received Royal Assent in December 2023. The changes, intended to stimulate competition, include the removal of the defence for efficiency gains in merger and acquisition reviews and the expansion of some of the powers of the Competition Bureau and Competition Tribunal. In Budget 2024, after years of consultation, the government has proposed a *Consumer-Driven Bank Act* as a step in creating a framework for "open banking." Open banking has the potential to strengthen competition and innovation in financial services, although, realistically, on the current path a framework is still years away. Meanwhile, there has been little to no progress in modernizing rules for a digital economy. In particular, Bill C-27 that proposes to enact the *Consumer Privacy Protection Act* and the *Artificial Intelligence and Data Act* is languishing in committee in the House of Commons.

Building on the above, we add commentary on global relations and trade and investment, financial sector regulation, and recent developments in taxation and environmental regulation.

Clearly, *trade and investment policy* is now less about signing more free trade agreements than it is about managing key relationships in a fragmented and fractious global environment where economic security and national security are intertwined. There are three key imperatives.

- **Securing Our Relationship with the United States:** The next presidential mandate, under any administration, will force a reset of the relationship covering not only bilateral and continental trade, but global economic relations, the border, migrations, national security and defence, the Arctic, and other interests. The negotiation of CUSMA that preserved the fundamental benefits of NAFTA was a success for Canadian trade diplomacy and advocacy. The next round may be far more difficult because of more entrenched protectionist sentiment in the United States and wider, more intense geopolitical and trade tensions globally. There will be trade-offs in any negotiation, and not all Canadian vested interests may be protected.[2] The government will need to consult and analyze trade-offs carefully and be prepared not just to play defence but to put forward proposals that will be responsive to U.S. priorities while serving our vital interests. It will be important in planning a renegotiation of CUSMA to engage bilaterally also with Mexico.
- **Managing Our Relationship with China:** China is the second largest destination of our exports and the second largest source of our imports. While the United States has adopted aggressive policies to restrict trade and investment with China, particularly regarding what the United States considers sensitive or strategic sectors, Canada to date has not taken similar bold steps. With the latest round of increases in U.S. tariffs targeting, in particular, EVs and EV batteries, Canada faces intense pressure to follow suit. The United States is expecting that Canada, Mexico and other partners join their efforts to build viable supply chains in strategic industries, not reliant on Chinese imports. Our federal and provincial governments, together with investors that we have attracted with massive subsidies, as well as other domestic producers, equally are concerned that their investments not be undercut by cheap imports from China. Increased Chinese investment to produce EVs and components in Mexico raises similar preoccupations. Yet, imposition by Canada of new tariffs and investment restrictions would lessen competition and raise prices for consumers, and costs for producers. Moreover, measures to stem Chinese imports into Canada would invite retaliation. Managing this tension with China while also securing our relationship with the United States (and Mexico) may be one of the most delicate exercises ever for Canadian economic diplomacy. It will require a medium- to long-term perspective, yet a capacity for quick response and adjustment.

- **Defending Our Interests and Building Resilience While Continuing to Pursue Gains from Trade:** Despite global tensions, governments and businesses have to resist protectionism and pursue trade and investment opportunities with a Team Canada mindset.

There is a case to review aspects of *financial sector regulation* to determine how more of the savings of Canadians can be channeled efficiently to productive investment. Canada has been remarkably successful at fostering a stable financial system. Additionally, a suite of policy tools historically has facilitated an ample supply of bank lending for housing. As seen in Chapter 1, Canada outranks other developed economies in investment in housing. More such financing is yet required, but there is a case to review how policy and regulation are affecting the supply of capital for productive investment. Recent initiatives may be working at cross-purposes.

- Budget 2024 announced new guidance to Crown financial institutions (Business Development Bank of Canada, Export Development Canada, Farm Credit Canada) "to mobilize more financing, and take on greater risk, in order to get more support to the Canadian businesses that need it."

- At the same time, the Office of the Superintendent of Financial Institutions (OSFI) is requiring Canadian banks to implement Basel IV requirements for calculation of the risk-weighted assets that they hold against their capital by 2026, ahead of some global competitors; this is likely to diminish available funds for lending to corporations and households—by as much as 9% of GDP according to an estimate by Scotiabank.[3]

- A sound financial system is one that is stable but also one that has a reasonable tolerance for risk-taking. The balance, across all channels of financing for businesses, should be assessed very carefully given Canada's chronic gap in productive investment.

- Meanwhile, some have advocated requiring pension funds to allocate a greater share of their assets in Canada. In the Annex, we comment that such prescriptive policy would be misguided. However, there is value to a dialogue, as launched in Budget 2024, on "how to catalyze greater domestic investment opportunities for Canadian pension funds."

Likewise, *Tax* must be addressed as part of the strategy to incentivize saving and investment, not as a set of one-off measures. Recent decisions illustrate the need for a coherent and integrated approach.

- Budget 2024 raised the **inclusion rate on capital gains** realized annually above $250,000 by individuals, and on all capital gains realized by corporations and trusts, from one-half to two-thirds effective June 25, 2024. The government suggests that the measure increases tax fairness and that it will affect only a small proportion of taxpayers. Some submit that it will dampen investment at the worst possible time. There is no definitive science to a proper inclusion rate for capital gains, but two facts stand out. First, the measure evidently was introduced to meet a short-term revenue requirement for the government. By giving taxpayers time to crystallize gains before the change, the government projects that the measure will raise $6.9 billion in 2024–2025, conveniently keeping the projected deficit for that year just under $40 billion. Second, while introduced together with a Canadian Entrepreneurs' Incentive,[4] the measure does not directionally nor logically fit into any strategy or wider tax reform to promote investment and productivity growth.

- Concurrently, the federal government is phasing out the **temporary accelerated cost allowances** that it introduced in 2018 in response to U.S. tax reforms. The full expensing of investment in M&E for manufacturing and processing, and the provision of an Accelerated Investment Incentive "for businesses of all sizes, across all sectors of the economy, that are making capital investments" will be sunset by 2027.[5] The 2018 measures reduced appreciably the marginal effective tax rate on new investment and thus improved tax competitiveness. The investment response may have been disappointing, but the phase-out—representing an effective tax increase—is unlikely to help correct trends.

- Meanwhile, the government is delivering "**major economic investment tax credits**," many of them refundable and thus tantamount to grants, for clean electricity, CCS, hydrogen, and the EV supply chain. Each of the tax credits comes with its own set of detailed criteria and conditions. The credits may be critical to accelerate investment in the energy transition, but together they also complicate considerably the tax code, and they may distort investment choices in ways not fully predictable or productive.

- Many experts consider that the time has long come for a comprehensive review and simplification of the tax code. The last overhaul was in the 1980s. It is questionable whether one exercise could cover in a reasonable period of time the full scope of the tax system. However, a stepwise effort with annual instalments, founded on clear principles and with a focus on means to stimulate saving and risk investment, could deliver improvements over time by ensuring purpose, coherence, and integrity.

Finally, *environmental regulation*, including for major projects in the energy transition, remains a key preoccupation. With amended legislation and commitments in Budget 2024, efforts must focus on getting sound projects approved, permitted, and built faster. The *Budget Implementation Act 2024* (Bill C-69) has proposed amendments to the *Impact Assessment Act* intended to bring the Act into conformity with the Supreme Court opinion rendered in October 2023 in the reference case on the constitutionality of the Act. Whether the amended Act corrects the jurisdictional overreach of the original version may be determined in the courts.[6]

What is surely to be tested is whether the regulatory system can deliver decisions faster and enable projects that meet high environmental and social standards to get built. The government is creating a Clean Growth Office in the Privy Council Office roughly modelled on the former Major Projects Management Office (MPMO). Early evidence of progress on concrete projects will be necessary to improve the confidence of investors. At the federal level, a clear focus on effects within federal jurisdiction together with substitution or other arrangements with provinces to achieve the goal of "one project, one review" will be key.

PROVINCIAL PRIORITIES

It is unfortunate that in debates about policy directions to improve Canada's economic performance often little attention is paid to the roles of provincial, territorial, and local governments. As policy authorities, they have multiple levers to shape the investment environment. Their role in regional or national policy or programs through intergovernmental arrangements, collaboration, and leadership is equally significant. As economic actors, these governments together represent over 70% of the current expenditures and over 85% of the investment (e.g., infrastructure) of "general government"—far outweighing the federal government.[7]

Provinces are key players in support of some of the national priorities cited above.

- **Immigration:** Under Canada's 2024–2026 Immigration Levels Plan, 40% of economic immigrants will be admitted to Canada under the Provincial Nominee Program that enables provinces and territories to choose immigrants according to their economic needs.[8] Provincial policies for post-secondary education, including the funding of universities and colleges, also affect the intake of foreign students and the participation of this population in our labour market. The recognition of credentials is also a matter that falls under provincial jurisdiction. It affects not only the capacity of newcomers to make the best contribution to the economy, but also the regional mobility of workers in Canada.

- **Competition:** Internal barriers to trade are important impediments to competition. As observed in a working paper by the IMF: "Non-tariff trade barriers (NTBs) exist due to different regulations across provinces. ... The collection of these regulatory distortions can have important macroeconomic effects, as NTBs hinder labour mobility, limit choice for consumers, fragment markets, stifle competition, and limit the effective scale of production thereby lowering productivity growth."[9] The authors estimated that "complete liberalization of internal trade in goods could increase GDP per capita by about 4 percent." The federal government is advancing an action plan to strengthen internal trade, but provinces are in the driver's seat and progress to date has been painfully slow.

- **Environmental Regulation:** The building of projects, from large public or private infrastructure to mines or to housing development, is subject to review and permitting by many provincial and local authorities. Like federal processes, provincial or local ones can be lengthy, adding to project costs and creating uncertainty. All levels of government have to work together to coordinate and streamline their processes to give investors greater confidence and ultimately to reduce costs and improve the returns to investment.

- **Financial System Regulation:** Provinces have many levers, including jurisdiction over securities, that can affect the mobilization of savings and the channeling of those savings into productive investment. The EU is contemplating a Capital Markets Union that could again draw into question why Canada requires 13 regulators to oversee our small market.

- **Taxation:** Provinces largely align their income tax structure with the federal one, but rates of tax and special provisions (e.g., deductions or credits) in provincial tax codes can also have a material impact on decisions to work, save, and invest.

- **Trade:** Canada best advances its interests when federal and provincial governments, with businesses, work together under a Team Canada approach. As regards the Canada–U.S. relationship, provincial engagement with U.S. states can be instrumental.

In these and other domains, provinces, working individually and with other provinces and the federal government, can help move the needle on productivity growth.

We cite two other priorities where provinces can exert leadership in ways particularly germane to the energy transition.

- **Expansion and Decarbonization of the Electrical Grid:** The growth of a clean economy over the next decades requires a large expansion of our clean electricity supply. Canada has a global advantage by starting with an electricity system that is close to 85% non-emitting, compared with about 40% for the United States.[10] The addition of new renewable and nuclear generation capacity, and the potential deployment of CCS technology for natural-gas generation units, can further raise the proportion of clean electricity in our total supply. In 2023, the federal government published draft *Clean Electricity Regulations* targeting a near-net-zero grid by 2035. There is ongoing discussion about the potential impact of the proposed regulations on electricity system cost, security, and reliability, indeed on the feasibility of achieving the federal targets in some regions of the country. However, there is broad agreement on the long-term goal of decarbonization. Concurrently, a large investment is necessary to meet the growing demand and to electrify energy systems in industry, transportation, and buildings.

A range of studies in Canada and in the United States have established that to meet energy and climate goals the electricity grid has to roughly double over the next 25 years—over and above the requirement to replace older assets and to decarbonize supply. The federal government has introduced a number of instruments, including new tax credits and financing mechanisms, to support investment in clean electricity, but the planning and execution by utilities is under provincial jurisdiction. This is an undertaking of unprecedented scale and speed to be pursued across all provinces based on their resources and technology choices. Most utilities and provinces have released plans to guide their investments over the next 10 to 15 years. For Quebec alone, planned investments and additional operating expenses to 2035 amount to $185 billion. Provinces have to ensure that policy and regulatory conditions and planning processes can accommodate the necessary rapid growth in public and private investment. Regulators will need to allow the costs of the new infrastructure to be reflected in the rate bases in a way that will enable the efficient and timely financing and construction of the projects.

- **An Integrated Market for Carbon Credits:** Most of the public attention over carbon pricing focuses on the federal fuel charge that is paid by consumers in most jurisdictions, under the federal backstop.[11] However, the instrument that is the most significant is the industrial carbon price that applies to large emitters and that is designed and administered separately by each jurisdiction except Prince Edward Island, Manitoba, the Yukon, and Nunavut.[12] The Canadian Climate Institute estimates that while the fuel charge may contribute 8–14% of incremental emission reductions between 2025 and 2030, the industrial carbon price, or the large emitter trading system, may account for 20–48% of incremental reductions, representing the most powerful instrument in the current suite of climate policies.[13] The difficulty is that the provincial systems, while meeting minimum national standards, operate independently, have different rules, do not allow a trading of credits across jurisdictions, and thus do not foster an efficient, integrated carbon credit market. Investors in large emission abatement projects that seek to sell credits to offset costs and to achieve a return on their investment do not have access to buyers outside of their province. Conversely, emitters that seek to buy credits as the most cost-effective means of complying with their obligations cannot do so out of province. It would be entirely within the authority of provinces to collaborate voluntarily with the federal government to establish a harmonized and integrated industrial-pricing system that would facilitate compliance for all industrial emitters, allow the trading of credits across jurisdictions, incentivize investment, and help achieve emission reductions at the lowest cost.

CONCLUDING OBSERVATIONS

There is no single federal or provincial policy or set of policies that, all else unchanged, could alter decisively and quickly trends in saving, investment, and productivity growth.

Moving the needle will take time, and it will require a coherent and complementary set of actions by federal and provincial governments working together with businesses.

Overall, policy at both the federal and provincial levels must give priority to raising output per worker and GDP per capita. If, alternatively, this objective is subsidiary to all other policy pursuits, then we will be dividing a static or shrinking pie and likely falling further behind other nations.

ANNEX

Saving and Investment: Insights from Canada's International Accounts

As reviewed in Chapter 1, international comparisons of growth in GDP per capita and productivity since the GFC of 2007–2008 show Canada stagnating and lagging behind the United States and some other developed economies. Over this period, Canada has allocated a larger part of its domestic saving to residential investment than its peers while under-investing in productive capital per worker.

It is instructive to analyze trends in current and capital financial flows in and out of the country as another lens on the economy over this period. Despite a persistent, small current account deficit, Canada has built a net international asset position. The trends reveal rising net *borrowing* from abroad to meet domestic needs and rising net *equity* investment abroad to realize economic value.

Our economy, which is largely dominated by resources and financial services, has not generated the same investment returns, in particular, as the more dynamic and innovative U.S. economy. Investors in search of returns, including Canadian investors, are placing more bets outside of Canada.

The behaviour of our investors is rational, and it supports growth in aggregate national income. However, if our domestic investment and innovation remain sub-par, our global competitiveness and capacity to generate rising wages, profits, and revenues for workers, corporations, and governments will be impaired and our standard of living will continue to diminish in relative, and indeed perhaps absolute, terms.

Budget 2024 announced a dialogue with Canadian pension funds led by former Bank of Canada Governor Stephen Poloz on ways to grow their investment in our country. This exercise may be productive if it focuses on policies and business conditions needed to create opportunity and raise expected investment returns in Canada relative to what may be earned abroad. Indeed, investment in Canada must grow because of opportunities to deploy capital productively and to earn attractive returns, not because of rules that would render captive the savings of Canadian pensioners.

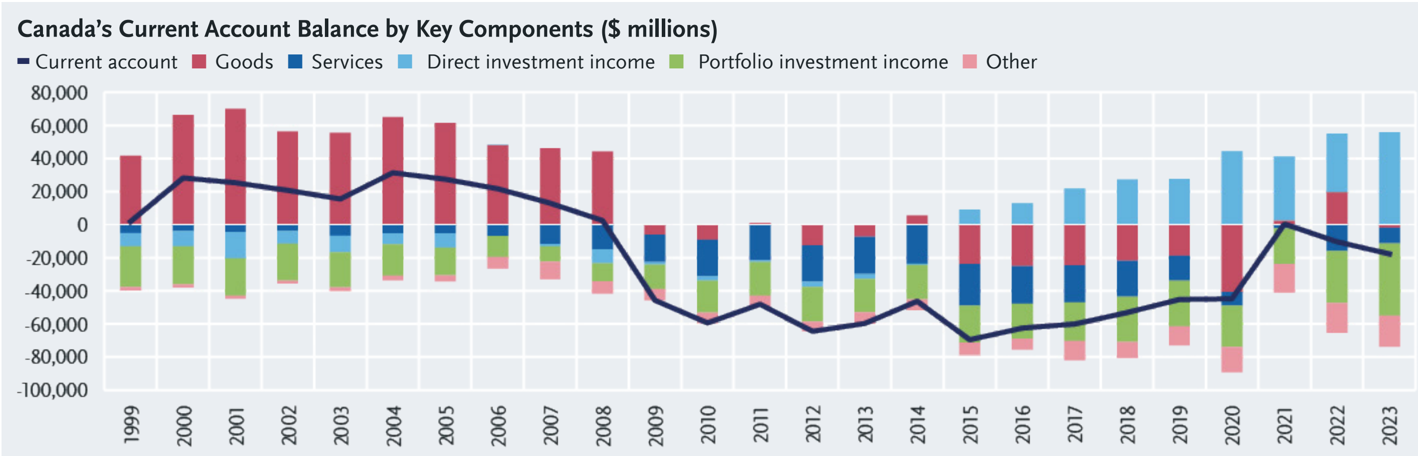
THE CURRENT ACCOUNT

The current account of the balance of payments captures current transactions with the rest of the world. It tracks current receipts and payments for goods and services (exports and imports), as well as current income flows in and out of the economy in the form of returns on international (direct and portfolio) investments. A current account deficit is recorded in any period when total current payments to non-residents exceed total current receipts from non-residents.

Canada shifted in 2008 from modest current account surpluses to modest deficits as U.S. demand for our exports plummeted and our merchandise trade balance went from positive to negative (Chart A.1). A services trade deficit also worsened around 2008, although it later recovered, including through COVID because of lesser net outbound international travel. Through the period, there was a consistent net outflow of portfolio investment income—for example, Canada paid out net amounts of interest and dividends on securities. By contrast, since 2015 there has been rising net direct investment income: our firms have been realizing more earnings on their direct investments abroad than multinational corporations have earned on their investments in Canada. In part, this reflects developments in our oil and gas sector. The sharp drop in world oil prices in 2014 together with regulatory delays and uncertainty in getting projects built diminished returns and the incentive for foreign investment and reinvestment in the sector.

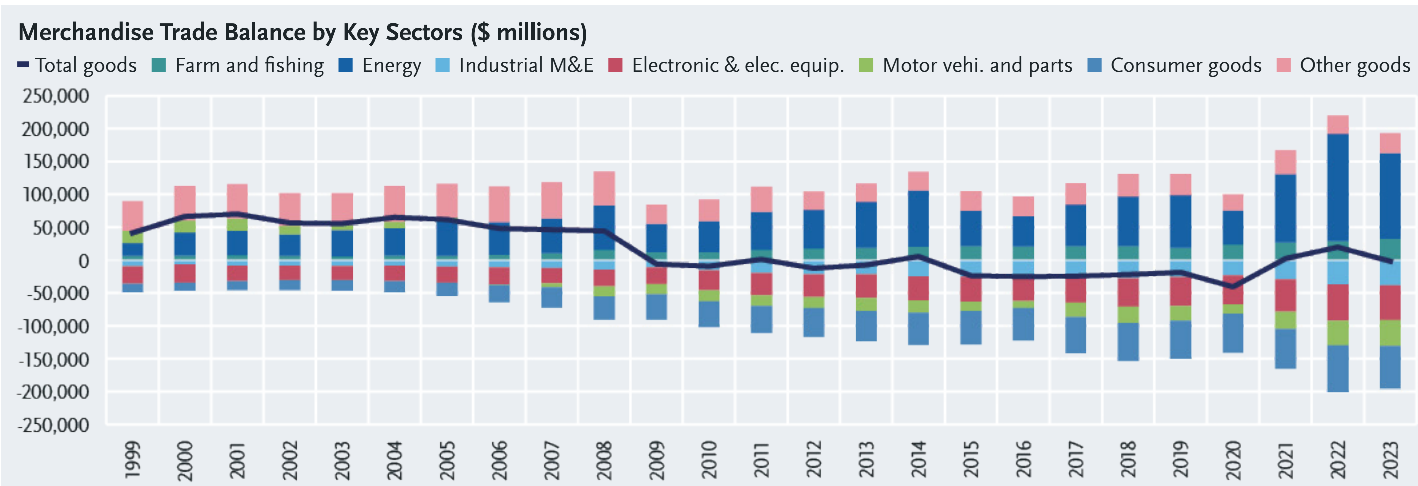
"The analysis is this chapter is based on data to the fourth quarter of 2023, as available prior to May 30, 2024."

CHART A.1



Source: Statistics Canada, table 36-10-0014-01.

CHART A.2

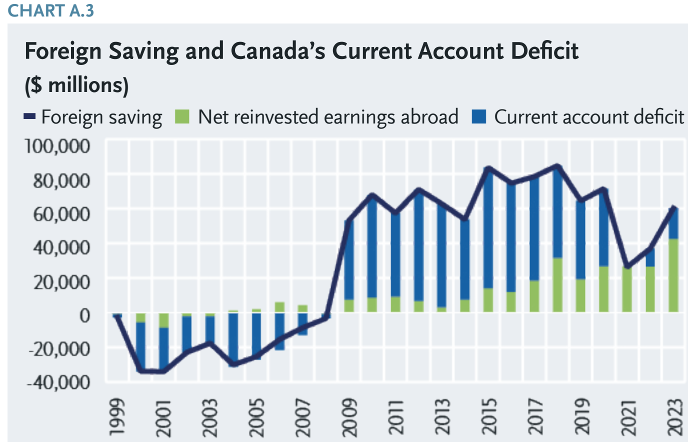


Source: Statistics Canada, table 36-10-0020-01.

Through the period, despite intervals of low oil and gas prices, net energy exports funded a large share of our net imports of other goods, helping to contain what would otherwise have been larger merchandise trade and current account deficits (Chart A.2). The data on goods again shows a discontinuity around the GFC. The balance for motor vehicles and parts went from slightly positive to slightly negative in 2007. Historical deficits for electronic and electrical equipment, industrial machinery and equipment, and consumer goods continued and even grew. Net energy exports have been a critical offset. Since 2021, with firmer prices through global recovery from COVID, net energy exports have pulled merchandise trade into rough balance.

The persistent current account deficit together with net reinvested earnings on direct investment have necessitated as a counterpart a regular inflow of foreign saving (Chart A.3). As observed above, net earnings on direct investment abroad have reduced Canada's current account deficit. In a large proportion, these net earnings are reinvested. Unlike the distributed portion, the reinvested portion of net earnings does not amount to an inflow of cash. Thus, the actual flow of funds into Canada, or *foreign saving* as defined in the national accounts, is equivalent to the current account deficit, *plus* the amount of net reinvested earnings on direct investment abroad. Since 2008, the inflow of foreign saving has been consistently positive, representing the current account deficit, albeit small since 2021, and rising net reinvested earnings on direct investment.

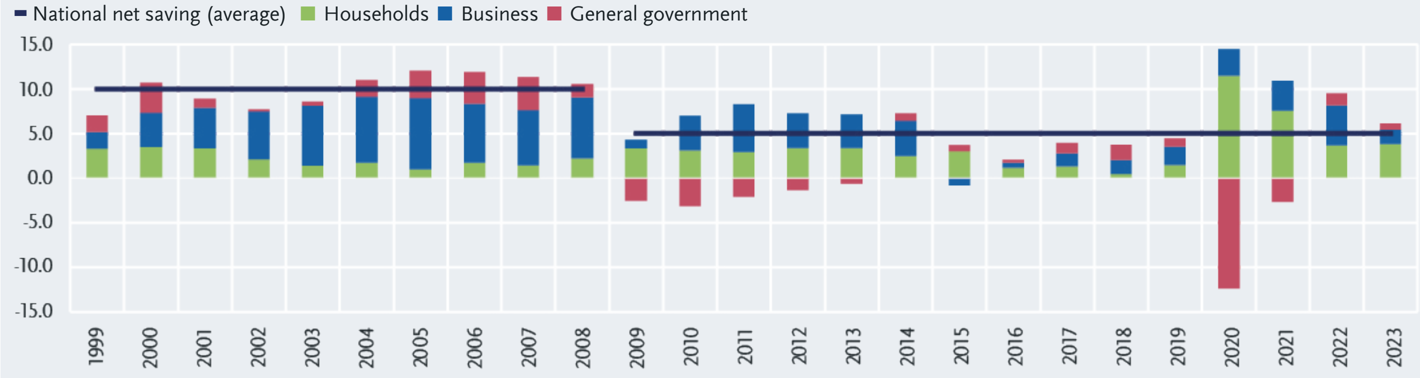
CHART A.3



Source: Statistics Canada, table 36-10-0121.01.

CHART A.4

National Net Saving as % of National Disposable Income by Sector in Canada



Source: Statistics Canada, table 36-10-0111-01.

The net inflow of foreign saving after 2008 coincided with a period of generally reduced net domestic saving as a proportion of our national disposable income (Chart A.4). Our domestic net saving rate dropped after the GFC with the sharp fall in our net exports, and then again in 2015 with the collapse of oil prices. The temporary burst in household saving in 2020 and 2021 and reciprocally in government dissaving are attributable to exceptional COVID-related transfers in a period also of lower-than-normal consumption.

THE CAPITAL ACCOUNT

Since the GFC, the foreign saving required by Canada has been secured largely by the issuance and the sale to non-residents of debt securities; through the period, there was generally a net outflow of investment in (portfolio and direct) equity investment.

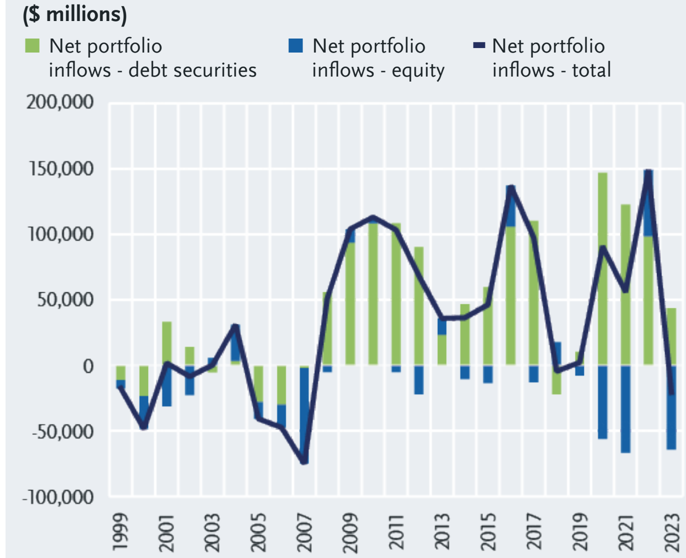
- Year-on-year, foreign investors have acquired more Canadian debt securities than Canadians have purchased foreign debt securities (Chart A.5). By contrast, years of net inflow in portfolio equity have been few and far between.
- Meanwhile, the net outflow of direct investment has comprised both new investment and the reinvestment of earnings abroad (Chart A.6). The net outflow grew after 2014, coinciding with the change of conditions in our energy sector and with large increases in the assets abroad of the finance and insurance industries.

In sum, in net terms, Canada borrows from abroad through debt securities (and banking transactions), while it grows its portfolio of foreign equities and direct investment (including by reinvesting its earnings).

The apparent bias of investors (Canadian and foreign) for debt securities in Canada and equities abroad is likely explained, at least in part, by the lower return on equity earned in Canada by foreign investors (taking into account revaluations as well as the exchange rate) than the return earned by Canadian investors on their investments abroad. For example, over the period of 2018 to 2023, foreign

CHART A.5

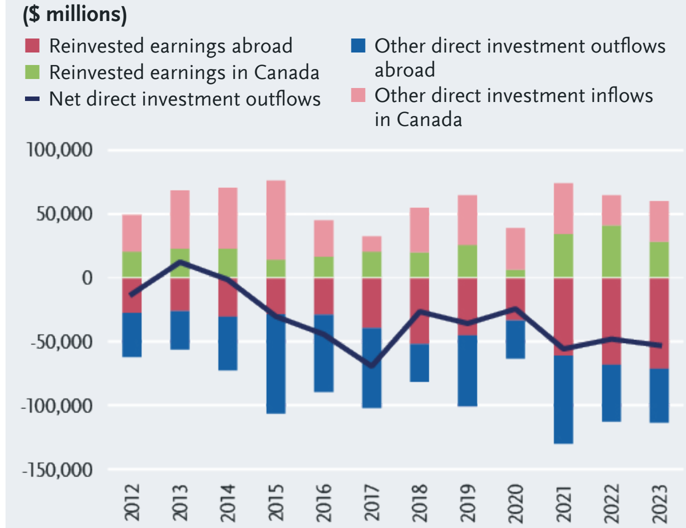
Net Portfolio Capital Inflows in the Financial Account
($ millions)



Source: Statistics Canada, table 36-10-0471-01.

CHART A.6

Direct Investment Capital Flows in the Balance of Payments
($ millions)



Source: Statistics Canada, table 36-10-0471-01.

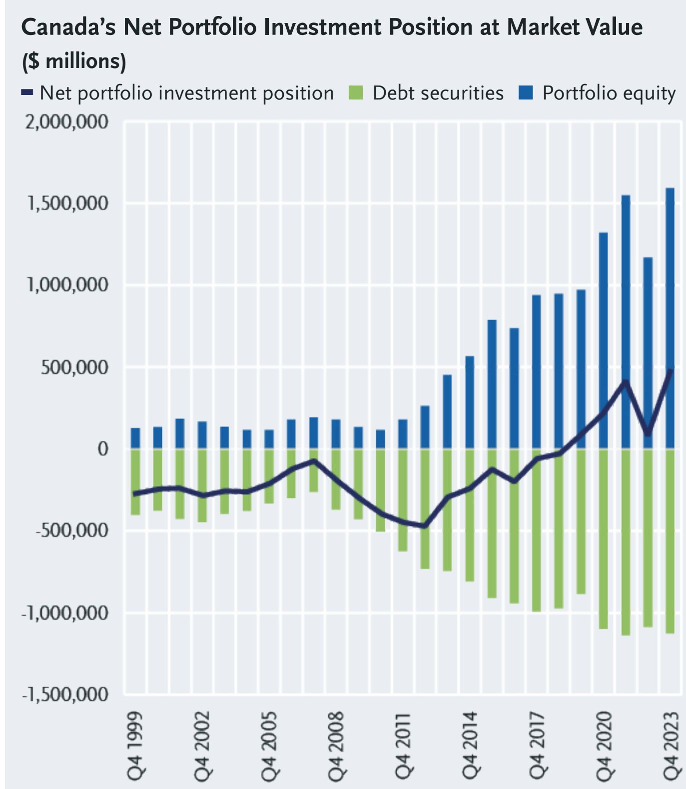
investors earned an annual return of 7.3% on their portfolio equity investment in Canada, compared with a return of 10% earned by Canadian investors abroad.[1] As an added data point, over the past 10 years the annualized return on the S&P TSX 60 index was 4.60%, compared with 10.63% for the U.S. S&P 500 index.[2] There are many factors at play, for example the uneven financial performance of Canada's resource-based industries over the period compared with the exceptional returns earned by U.S.-based tech leaders.

THE NET INTERNATIONAL INVESTMENT POSITION

As a result, despite its current account deficits, by borrowing abroad to invest in equities, and earning and reinvesting favorable returns, Canada has built up a net positive international investment position at market value.

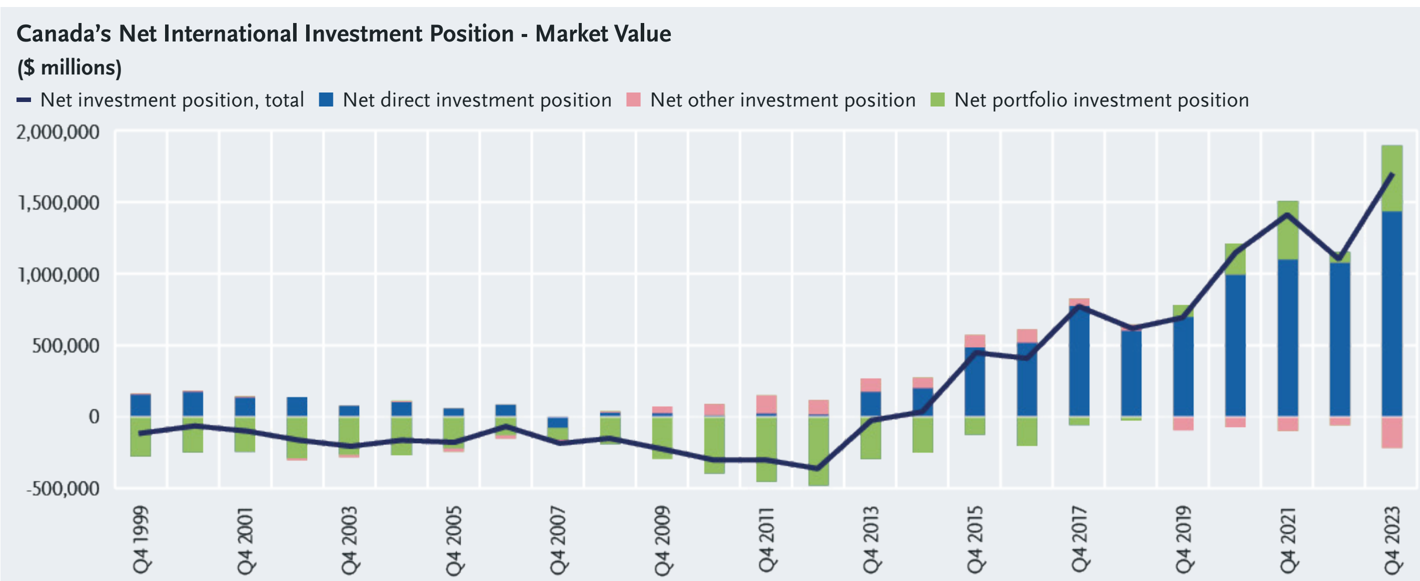
- The total net *portfolio* asset position, at market value, is now modestly positive (Chart A.7). There is positive portfolio equity position offset largely by a negative portfolio debt position.
- Meanwhile, since 2014 there has been robust growth in Canada's positive *direct investment* position.
- Correspondingly, our *total* net international investment position at the end of 2023 was $1.7 trillion at market value (Chart A.8).

CHART A.7



Source: Statistics Canada, table 36-10-0485-01.

CHART A.8



Source: Statistics Canada, table 36-10-0485.01.

CONCLUSION

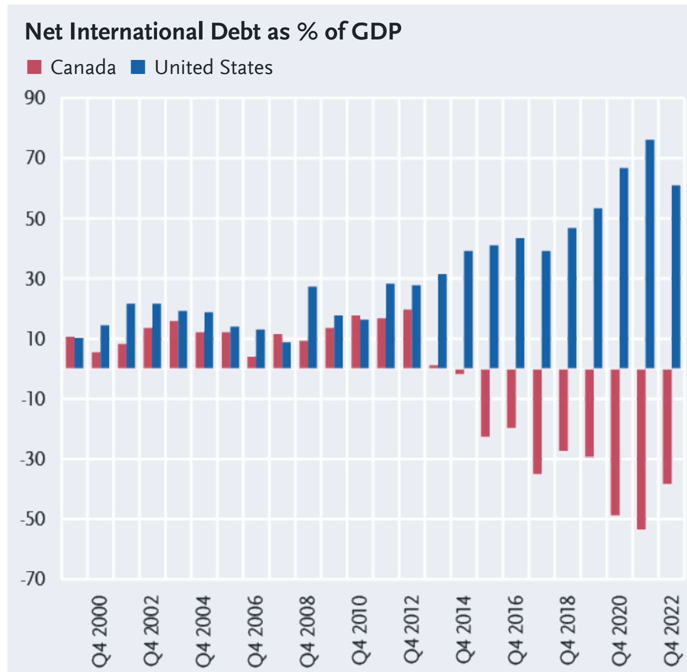
Taken alone, Canada's international accounts, including small current account deficits and a positive net international investment position, are enviable compared with the very large current account deficits and the net debt position of the United States (Chart A.9).

This said, the imperative for Canada today is less growing a net international asset position than mobilizing domestic and foreign saving for investment in the productive capacity of the domestic economy. Borrowing to invest abroad may be a successful strategy for an investment fund, but for an economy it is not a path to raise standards of living sustainably. The path forward is for governments and businesses to work together to create an environment in which domestic and foreign capital can earn the risk-adjusted returns that will grow investment in Canada and raise productivity and thus GDP per capita.

More risk investment in Canada by institutional investors, including our pension funds, may be part of the equation if driven by opportunity and not by rules. In an open letter to the Minister of Finance, many chief executives advocated that Canada should require our institutional investors, specifically our pension funds, to allocate more of their capital to equity investment in Canada.[3] This prescription misses the mark. It is not by rendering captive in Canada capital that rightly should be allocated to earn the highest returns for its owners, namely current and future Canadian pensioners, that Canada will secure greater wealth. Rather, it is by governments working together to put in place policy frameworks that attract risk investment, strengthen incentives for innovation, enhance competitive pressure, and facilitate adjustment for workers.

Against this background, it is appropriate, as proposed in Budget 2024, that a dialogue take place with our large pension funds to catalyze greater domestic investment opportunities that "meet Canadian pension plans' fiduciary and actuarial responsibility, spur innovation, and drive economic growth." The working group, led by former Governor of the Bank of Canada Stephen Poloz, may provide insight not only into investment opportunities but also critically into the conditions for success. While recognizing the urgency to act, the working group will best adopt a medium-term horizon and recommend integrated strategies as well as concrete early steps.

CHART A.9



Sources: U.S. Bureau of Economic Analysis and Statistics Canada, table 36-10-0485-01.

Notes

CHAPTER 2

1. White House, Fact Sheet: President Biden Takes Action to Protect American Workers and Businesses from China's Unfair Trade Practices, May 14, 2024, whitehouse.gov/briefing-room/statements-releases/2024/05/14/fact-sheet-president-biden-takes-action-to-protect-american-workers-and-businesses-from-chinas-unfair-trade-practices/.
2. See IMF Blog, The High Cost of Global Economic Fragmentation, August 28, 2023, imf.org/en/Blogs/Articles/2023/08/28/the-high-cost-of-global-economic-fragmentation. See also IMF Blog, Confronting Fragmentation Where It Matters Most: Trade, Debt, and Climate Action, January 16, 2023, imf.org/en/Blogs/Articles/2023/01/16/Confronting-fragmentation-where-it-matters-most-trade-debt-and-climate-action. WTO economists estimate that decoupling of the global economy into geopolitical blocs could reduce world GDP by 5% in the long run. See WTO, World Trade Organization, *World Trade Outlook and Statistics,* April 2024, wto.org/english/res_e/publications_e/trade_outlook24_e.htm. Economists from the European Bank for Reconstruction and Development (EBRD) have estimated the economic costs of friend-shoring to up to 4.6% of GDP. See EBRD, Working Paper No. 274, December 2022, ebrd.com/publications/working-papers/economic-costs-of-friend-shoring.
3. U.S. Bureau of Economic Analysis, bea.gov/sites/default/files/2024-03/trad-geo-time-series-0124_0.xlsx.
4. WTO, *supra,* footnote 3.
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7. See IEA, Net Zero Roadmap: A Global Pathway to Keep the 1.5°C Goal in Reach, September 2023, iea.org/reports/net-zero-roadmap-a-global-pathway-to-keep-the-15-0c-goal-in-reach/executive-summary; also see IEA, *World Energy Outlook*, October 2023, iea.org/reports/world-energy-outlook-2023/executive-summary.
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9. The target and the compliance mechanisms are still being discussed further to the publication in August 2023 of the draft *Clean Electricity Regulations.* See Environment and Climate Change Canada, *Clean Electricity Regulations,* Public Update, February 16, 2024, canada.ca/content/dam/eccc/documents/pdf/climate-change/clean-fuel/electricity/clean-electricity-regulations-public-update-16022024.pdf.
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CHAPTER 3

1. For example, growth as measured by the quarterly growth rates for the G-20 during 2023, at 3.2%, is equivalent to the Q4-over-Q4 growth rate for the world economy, as estimated by the IMF in its latest World Economic Outlook.
2. World Bank, *Commodity Markets Outlook,* April 2024, bit.ly/CMO_Spring2024_FullReport.
3. IMF, Fiscal Monitor database, April 2024, Table A.2, imf.org/en/Publications/FM/Issues/2024/04/17/fiscal-monitor-april-2024.
4. Bank of Canada, Monetary Policy Report, April 2024, bankofcanada.ca/2024/04/mpr-2024-04-10/.

CHAPTER 4

1. The phrase was evoked during the GFC by then U.S. Treasury Secretary Timothy Geithner. See his book: *Stress Test - Reflections on Financial Crises,* 2015.
2. An example of highly questionable policy and negotiation strategy is Private Member Bill C-282, *An Act to amend the Department of Foreign Affairs, Trade and Development Act (Supply Management)*. The Bill proposes to preclude any concession in Canada's trade agreements on supply management for dairy products, poultry or eggs. By tying the hands of our negotiators in this fashion, our counterparts in the negotiation benefit. The Bill was approved by the House of Commons at Third Reading in June 2023 by a vote of 262 to 51. The Bill was referred in April 2024 to the Senate Standing Committee on Foreign Affairs and International Trade.
3. Jean-François Perreault, *Scotiabank Global Economics – Insights and Views,* Does the Federal Government Really Want Banks to Lend Less, May 24, 2024, scotia.bluematrix.com/links2/pdf/8af62011-5804-48de-8992-bb67d5a93aee.
4. The Canadian Entrepreneurs' Incentive will reduce the inclusion rate to 33.3% on a lifetime maximum of $2 million in eligible capital gains.
5. Government of Canada, Fall Economic Statement 2018, budget.canada.ca/fes-eea/2018/docs/statement-enonce/toc-tdm-en.html. See also Trevor Tombe, Canada just started the largest tax increase you've never heard of, *The Hub,* May 16, 2024, thehub.ca/2024-05-16/trevor-tombe-canada-just-introduced-the-largest-tax-increase-youve-heard-of/.
6. See Martin Ignasiak, David Bursey and Lisa Rodriguez, *Bennett Jones Blog,* Impact Assessment Act Amendments Announced: Many Questions Still Left Unresolved, May 06, 2024, bennettjones.com/Blogs-Section/Impact-Assessment-Act-Amendments-Announced-Many-Questions-Still-Left-Unresolved.
7. The numbers are on a national accounts basis and represent, for 2023, the provincial, territorial and local share of general government for: (i) current expenditures excluding transfers to other governments and net interest costs; and (ii) gross fixed capital formation.
8. See Immigration, Refugee and Citizenship Canada, Notice – Supplementary Information for the 2024-2026 Immigration Levels Plan, November 1, 2023, canada.ca/en/immigration-refugees-citizenship/news/notices/supplementary-immigration-levels-2024-2026.html.
9. IMF Working Paper, *Internal Trade in Canada: Case for Liberalization,* July 2019, imf.org/en/Publications/WP/Issues/2019/07/22/Internal-Trade-in-Canada-Case-for-Liberalization-47100.
10. Natural Resources Canada, *Energy Fact Book, 2023-2024,* energy-information.canada.ca/sites/default/files/2023-10/energy-factbook-2023-2024.pdf.
11. The proceeds of the federal fuel charge remain in the jurisdiction in which they are collected. The fuel charge does not apply in Quebec, British Columbia and the Northwest Territories that have their own carbon pricing systems considered to have comparable effect.
12. The industrial carbon price designed by provinces must meet minimum national stringency standards established by the Government of Canada under the "federal benchmark". In Prince Edward Island, Manitoba, the Yukon and Nunavut, the industrial price is set under the federal Output-Based Pricing System as the backstop.
13. Dale Beugin, Anna Kanduth, Dave Sawyer, Rick Smith, *Canadian Climate Institute,* Which Canadian Climate Policies Will Have the Biggest Impact by 2030? March 21, 2024, 440megatonnes.ca/insight/industrial-carbon-pricing-systems-driver-emissions-reductions/.

ANNEX

1. Statistics Canada, table 36-10-0454-01, International investment position: quarterly change in Canada's international investment position, market value, and table 36-10-0002-01, Balance of international payments, current account, investment income, by type and sector.
2. As of June 3, 2024. See S&P Dow Jones Indices, spglobal.com/spdji/en/index-family/equity/.
3. The open letter concludes by saying that "Given their importance to the Canadian economy we, the undersigned, would support an effort by the Minister Finance of Canada and the Provincial Ministers of Finance to amend the rules governing pension funds to encourage them to invest in Canada. Consideration should also be given to incentivize other investors to allocate more capital to domestic investment. See: Open letter to the Minister of Finance of Canada and Provincial Finance Ministers, lba.ca/publication/open-letter-canada/.

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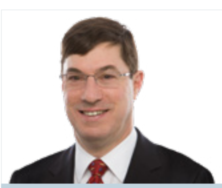

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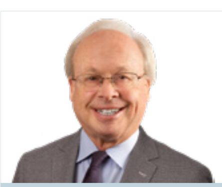

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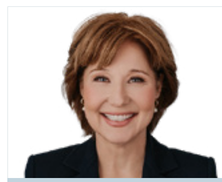

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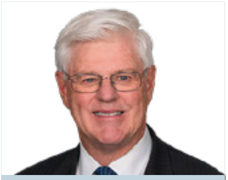

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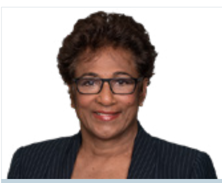

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