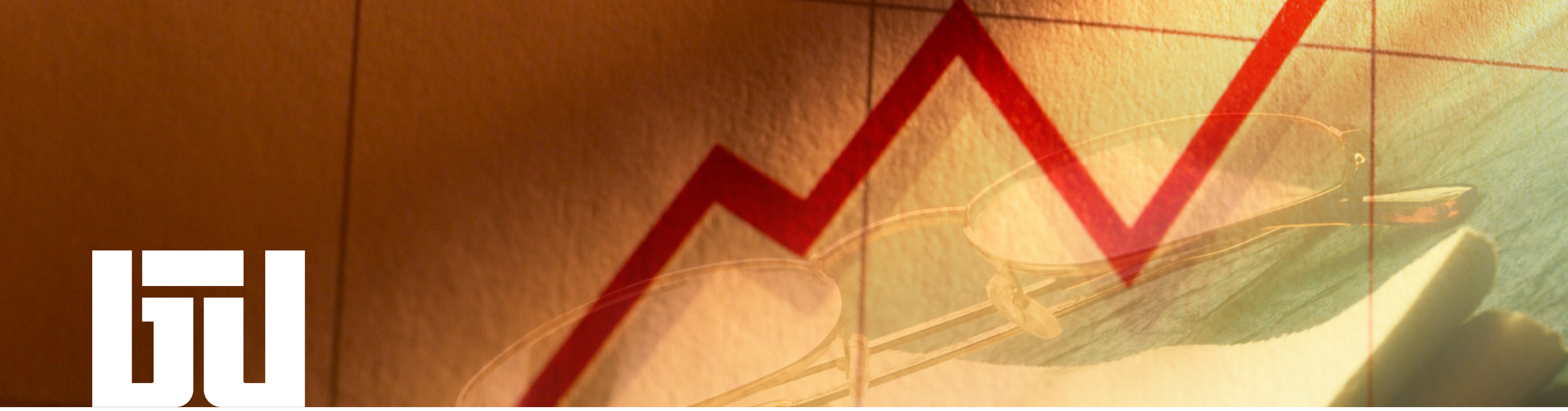

Bennett Jones Spring 2010 Economic Outlook

May 17, 2010 - David A. Dodge O.C., John M. Weekes and Richard Dion

As the Canadian economy recovers, Bennett Jones provides its perspective on economic trends that will influence Canadian business throughout 2010 and beyond. This economic update reviews the short-term outlook for the Canadian and world economies, discusses the policy adjustments that are needed to support growth beyond the recovery, examines the fiscal challenge Canada faces in the medium term, highlights international trade issues and negotiations underway, and draws implications of this uncertain macroeconomic evolution for Canadian businesses. Look for the Autumn 2010 Economic Outlook in November 2010.

I. Short-Term Outlook

The economic recovery over the last nine months (both in advanced and emerging economies) has been stronger than expected a year ago. Confidence among households and firms and in financial markets has markedly improved. With both monetary and fiscal stimuli continuing to support domestic demand over the next 18 months, albeit to a gradually declining extent, world growth should slightly exceed 4% in both 2010 and 2011 (Table 1). Although rebounding with less force than in past cyclical rebounds, real GDP growth should nevertheless reach over 3% in the United States and over 3½% in Canada in 2010, and keep going at 3-3½% in both countries in 2011. By the end of that year, excess capacity in Canada should be absorbed and interest rates should have progressively risen to 3-3½% at the short end (T-bills) and around 5% at the long end (10-year Canada). After rapid gains in the last year, mostly as a result of strong growth in emerging economies, commodity prices should continue to rise but at a more moderate pace as supply responds. Over the next two years, these firm commodity prices should support a strong (close to parity with USD) but still rather volatile Canadian dollar. Persistent downward pressures on the Euro as a result of relatively slow growth in Europe and the uncertain resolution of debt problems are also likely to support a strong Canadian dollar.

Table 1: Prospects for Global Growth (%):

	2009	2010	2011
United States	-2.4	3.0	3.0
Canada	-2.6	3.5	3.0
World	-1.1	4.2	4.0

II. Policy Adjustments

The outlook beyond 2011 is more uncertain. It importantly hinges on how economic policies evolve: fiscal correction in advanced economies, domestic inflation control in emerging economies, and exchange rate management. The economic outcome is uncertain because, as the IMF (2010) puts it, "room for policy maneuvers in many advanced economies has either been largely exhausted or has become much more limited, leaving these fragile economies exposed to new shocks."[1]

To facilitate continued growth with low and stable inflation, advanced economies need to undertake fiscal consolidation, but at a measured pace in order not to derail the upturn. While tighter budgetary policy will tend to dampen growth of domestic demand, the extent of dampening depends on the credibility and composition of the corrective measures. Credible medium-term plans for stabilizing and eventually reversing the rise in public debt should enhance private demand by giving markets and citizens confidence that the fiscal situation is under control. This would prevent or limit the risk of an increase in the sovereign risk premium in interest rates and of a rise in inflation expectations. Fiscal consolidation would also permit more accommodative monetary policy. The composition of expenditure and tax measures should be chosen to minimize their negative effect on labour supply and private investment in order not to depress future potential growth.

In the Eurozone, fiscal deficits have so ballooned with the end of the property bubble and the onset of the recession that fiscal retrenchment of exceptional severity is being forced by financial markets on

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high-deficit countries. Fiscal retrenchment, while necessary, will depress growth for years to come and, along with a weaker Euro, will make it more difficult for Canadian firms to increase exports to EU countries.

Emerging economies in general have experienced relatively strong growth and renewed capital inflows in the last year, giving a boost to property and consumer prices. In a number of countries, significant upside inflation risks in a context of strong growth and limited spare capacity imply the need for (further) monetary policy tightening. Prospects of relatively wide interest rate differentials in their favour over the next few years mean that many emerging economies will have to cope with substantial private capital inflows and further upward pressure on their currencies. The pressures on both their productive capacity and their currency are best addressed by constraining credit growth and allowing exchange rate appreciation. The impact of the resulting loss of net exports on growth could be gradually offset by the effect of policies to stimulate household demand, be they social policies or further development in financial systems to improve household access to finance. Currency appreciation itself would help East Asian economies to rebalance growth.

Without appropriate policy action in both advanced and emerging economies, current account imbalances, which shrank during the recession, are poised to rise noticeably again. Without policy cooperation between deficit and surplus countries, political resistance to fiscal consolidation and structural reform in advanced economies would increase, there would be a resurgence of protectionism (see Section IV for trade analysis), global growth would slow, and exchange rates and asset prices would be volatile. But if emerging economies let their currency appreciate and stimulate domestic demand while in advanced economies governments consolidate their finances and the household and financial sectors slowly delever, then the chances for reasonable global growth beyond 2011 are improved.

With appropriate policy coordination, global growth could be sustained at about 4% over 2012-15, reflecting growth of about 6% in emerging economies and 2½% in North America. In such a context, commodity prices would remain relatively strong. Relatively robust profit margins could get eroded for a while by increases in real wages as they adjust to tighter labour markets. The cost of bank credit will likely rise relative to the return on risk-free assets as the financial system reform raises banks' capital ratios.

III. Canada's Fiscal Challenge

Canada shares with the rest of the OECD the task of bringing government deficits into balance and reducing public debt relative to GDP in the medium term. This is needed not only for intergenerational equity but also to cope with the increasing effects of population aging. The federal and provincial 2010 budgets plan to reduce deficits over the next three years largely by compressing program spending growth through public wage freezes and attrition. This can work for only a limited period. Unless governments act to improve public sector productivity, restructure spending and/or increase revenues beyond the short horizon of their latest budget initiatives, structural deficits, which amounted to almost 2% of GDP prior to the recession, are bound to rise again.

Over the remainder of this decade, federal and provincial revenues are set to grow more slowly than in previous decades. Because of population aging, real potential growth in Canada is not likely to exceed 2½% over 2012-15 and 1¾% over 2016-20 (See box on next page for more details). As a result, federal government revenues would not grow faster than 5% per year on average over the period 2013-2020. Without significant restructuring, direct program expenses are set to increase at a rate at least as fast as nominal GDP growth, and so are transfers to provinces given fiscal pressures arising from health and education. A federal structural deficit of about ¾% of GDP in 2014/15 would slowly rise to nearly 1% of GDP by the end of the decade.

The fiscal outlook for the Ontario government is much worse than for the federal government. From 2013 to 2020, Ontario revenues are likely to grow at no more than 4½% on average—more slowly than federal revenues, reflecting Ontario's slightly slower potential growth rate than that of Canada as a whole. Ontario is also likely to experience less positive, if not negative, effects from rising commodity prices. On the other hand, Ontario expenditures are poised to rise much faster than nominal GDP if current levels and quality of services are to be maintained. In particular, spending on health and long-term care are poised to grow much faster than general revenues, and so are debt service payments as interest rates rise to more "normal" levels and government debt keeps growing. The structural deficit may well rise to over 3% of gross provincial product by mid decade and to about 5% by the end of the decade if current service levels are maintained and there is no dramatic improvement in productivity in the health and education sectors. By that time, the ratio of the net provincial debt to GDP may possibly reach 60%, compared with 28% in 2008/09.

In its 2010 budget, the Alberta government balances its budget by 2012-13 but only thanks to substantial revenues from royalties and lease payments. Arising from the depletion of natural resources capital, these special revenues are appropriate to fund public capital spending but not public

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Canada's Potential Growth Rate: 2012-2020

Real potential output is likely to grow at a little over 2% per year from 2012 to 2015 and at a little over 1½% in the second half of the decade (See Table 2 below). This reflects a slowdown in the growth of total hours worked to about ¾% per year in 2012-2013 and ¼% per year by 2019-2020. The key factor is the aging of the population as labour force participation falls precipitously for age groups beyond 55 years of age, even taking into account an expected rise in retirement age. Trend labour productivity, on the other hand, may grow a little faster than the historical average of 1.2% per year since the late 1970s, especially since the shortfall in productivity level relative to the U.S. has grown substantially since the late 1990s. A key factor is that with lower effective marginal tax rates on investment, a strong Canadian dollar and more wage pressures as labour supply growth slows, business investment and capital per worker would increase more rapidly than in the past.

Consistent with Bank of Canada current policy objectives, a general inflation rate of 2% is to be expected over the decade from 2012. At the same time, Canada's terms of trade may well show a modest upward trend as a result of generally firming commodity prices. Combined with real potential growth, these expected price developments would result in nominal potential GDP growth in the order of 5% per year from 2012 to 2015 and a bit less in the second half of the decade.

Table 2: Outlook for Canada's Potential Growth: 2012-2020*

	2000/2007	2012/2015	2016/2020
Hours	1½%	¾%	¼%
Productivity	1%	1½%	1½%
Real Potential Growth	2½%	2¼%	1¾%
Inflation	2%	2%	2%
Contribution of Terms of Trade	2-2½%	¾%	¾%
Nominal Potential Growth	6½-7%	5%	4½%

* annual average

consumption. It turns out that in 2012-13 the surplus of revenues from resources over the provinces' capital plan (including off-budget capital investment) falls short of the deficit based on normal revenues and operating expenses and that under plausible assumptions this shortfall grows as time goes by. The implication is that the Alberta government cannot escape taking fairly severe expenditure and tax measures to bring to balance its operating deficit if it is to convert its natural resource capital into public capital and wealth for future generations and not to dissipate it on current public consumption.

To achieve and maintain (cyclically-adjusted) balanced budgets over the medium term will require both expenditure and tax initiatives from the federal and provincial governments. But, this must be done in a way that has the least negative impact on incentives to work, to invest and to increase productivity. This means revenue-increasing measures should focus on consumption taxes (with appropriate refunds to low-income groups) as well as new or higher fees for services (roads, health care, post-secondary education). Expenditure reductions should focus on current services and not on capital investment.

IV. International Trade Issues and Negotiations

World trade and output are currently in a recovery phase, following a 12.2% decline in 2009. The WTO Secretariat[2] estimates that world exports in volume terms will grow by 9.5% this year.

Without leadership from G20 heads of government in committing to resist protectionist pressures, the decline in 2009 could have been much worse. The record in keeping these commitments has not been perfect but major slippage has been avoided. It will be critical for G20 Leaders at their meetings in Toronto and Seoul to reaffirm their determination to resist protectionism. The political pressures on governments to find shortcuts to improving economic performance are still intense and, indeed, even growing on such issues as trade imbalances. Succumbing to such pressures would be a serious set back to global economic recovery. The G20 has the power to prevent this from happening and a credible track record from its performance up to now.

In the longer term it will be important for liberalization of trade and reform of the trade rules to keep pace with other reforms in the global economy. On this front the balance sheet is mixed. Despite repeated high level commitments to complete the WTO's Doha Round of trade negotiations in the short term, the WTO members are no further advanced than they were in 2008. Completing the Round is still important but to do so in 2010 is now out of reach.

At the same time, we are seeing a lot of bilateral and regional trade negotiations involving G20 countries – some recently completed, others in progress, and some new ones that have just started. One example is the TPP (the Trans-Pacific Partnership Agreement) in which Australia, Brunei Darussalam, Chile, New Zealand, Peru, Singapore, the United States and Vietnam are aiming to create a regional Asia-Pacific trade agreement. This development is noteworthy because it is the first initiative by the Obama administration to negotiate a trade liberalizing agreement. Another example is the Canada-Korea negotiation towards a bilateral FTA. We have also seen some unilateral trade liberalization moves, including by Canada in the recent federal budget.

Canadian trade negotiations policy has become more active recently, notably with the ongoing negotiation of a Comprehensive

Economic and Trade Agreement with the EU. Canada is also engaged in a number of other free trade negotiations, including one with Korea, and is exploring another with India. In addition, Canada has continued to support the completion of an ambitious WTO Doha Round agreement. However, in pursuing its trade liberalization objectives Canada is hampered by its commitment to maintaining high tariff rate quotas on imports of dairy and poultry products. Refusal to negotiate any meaningful concessions in these sectors is making it difficult for Canada to get accepted as a partner in the TPP negotiations. It also tends to undermine Canada's efforts to achieve high quality agreements that will open markets for Canadian producers of goods and services that may be regarded as sensitive in other countries.

V. Implications for Business

Inasmuch as output increases faster than hours worked over the next year, the resulting cyclical rebound in labour productivity growth should generate a marked increase in corporate profitability on operations, particularly in the manufacturing sector, which was hardest hit in the downturn. As well, strong commodity prices and growing sales volume should boost profits in the energy and mining sectors.

These developments could not indefinitely offset the deleterious effect of a recent and prospective loss of Canadian competitiveness as measured by a comparison of unit labour costs in Canada and the U.S. This loss reflects a much slower rate of productivity growth in Canada as well as the appreciation of the Canadian dollar. Further down the road, faster wage growth as labour markets tighten should directly erode profitability for firms that have little pricing power and may exacerbate the competitiveness problem as well to the extent that labour market slack lasts longer in the United States. A less favourable labour supply situation in Canada than in the U.S. in the future, as a result of different demographics, would also contribute to more prospective wage pressure in Canada than in the U.S.

Canadian businesses need to take at least two challenging steps to improve their competitiveness. First, they must increase their productivity growth and catch up on the productivity levels of their competitors by investing more in organizational change, ICT and new machinery and equipment, R&D and the commercialization of its products, as well as worker training. They should be aided in this respect by the decline in the cost of capital associated with the appreciation of the Canadian dollar and the recent and upcoming reductions in the marginal tax rates on investment to extremely competitive levels. Second, to have a better chance to make inroads in emerging markets, where strong demand growth is concentrated, they must also invest in market research and in the design of differentiated products, for which absolute cost differences are less important as a sales factor. These fundamental efforts at strengthening Canadian competitiveness should be complemented by strong business support for open global markets and high quality trade agreements to ensure that Canadians can operate in global markets on an equal footing with their main competitors.

Notes

1 IMF. 2010. "Global Prospects and Policies." *World Economic Outlook* (April), Chapter 1, p.11. See Chapter 1 of the IMF's *World Economic Outlook* and the April 2010 *Monetary Policy Report* by the Bank of Canada for more detailed analyses of prospects and risks for the global economy.

2 For a more detailed presentation see WTO's March 26, 2010, press release, "World Trade 2009, Prospects for 2010," which can be found on the WTO website at: http://www.wto.org/english/news_e/press10_pr598_e.pdf.

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