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Where clients matter most.

Economic Outlook

Spring 2019

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Introduction

After a strong performance in 2017 and the first half of 2018, the global economy slowed markedly and is projected to grow at a more moderate but also more sustainable annual rate of 3.3% from 2019 to 2021. In Section I, we discuss our projections and the risks that need to be considered. We turn to a discussion of international trade developments and prospects in Section II, including the issues facing the World Trade Organization (WTO) and Canada. Building on the global economic and trade outlook, we set out the outlook for Canada over the next three years in Section III. In Section IV, we return to the analysis of the fiscal position of Canada and the four largest provinces, taking into account the evolving economic outlook and policies announced in 2019 budgets. As usual, we conclude with a summary of planning parameters for Canadian business over the 2019 to 2021 horizon.

Section I:
Global Growth to 2021

Recent Developments

After a very strong performance in 2017 and the first half of 2018, the world economy experienced a marked slowdown in the second half of 2018. Data indicates that growth has picked up in the first quarter of 2019, at least in advanced economies.

Both advanced economies and China lost **growth** momentum in the second half of 2018. In China, quarterly growth at an annual rate continued to decelerate slightly in the first quarter, to below 6.0%, although on a year-on-year basis growth remained at 6.4%, consistent with the official growth target. By contrast, growth in advanced economies picked up to an unanticipated extent in the first quarter, notably in the United States, the euro area, Japan and Great Britain. The buoyant 3.1% growth rate recorded in the United States, however, rests on a surge in net exports and business inventories, which in all likelihood will be soon reversed; growth in consumer spending and non-residential fixed investment, on the other hand, was much slower than in preceding quarters. The fading effect of the U.S. fiscal stimulus of 2018, trade policy disputes and the related uncertainty for businesses and government policies are two factors that have weighed on global growth in recent quarters.

Policy adjusted somewhat to the softer momentum of activity that became apparent in the latter part of 2018. The Chinese authorities have implemented modest fiscal and monetary stimulus measures in recent months. In light of recorded slower growth, persistently subdued inflation and considerable trade uncertainty, monetary policy in large advanced economies has lately shifted, perhaps temporarily, toward a more patient stance regarding the normalization of interest rates. The Federal Reserve has refrained from raising its interest rate after the December 2018 hike of 25 basis points and in March signaled a pause in its interest rate increases for the remainder of 2019. This signal was only a guide, however, as monetary policy remains "data dependent" (i.e. subject to change in light of new data, revised forecasts and changing risks). Likewise, the European Central Bank (ECB) announced in March that it further postponed a rise in interest rates to at least the end of this year. As investors reassessed the impact of trade uncertainty, U.S. bond yields dropped.

Excluding volatile elements, **inflation** in advanced economies has been stable or declining during the first quarter. In the U.S., core consumption expenditure (PCE) inflation was stable at 1.6% in the February to April period after declining from 2.0% in December 2018. Moreover, hourly earnings in the U.S. grew at an average annualized rate of only 2.6% in the first four months of 2019 despite unemployment rates at 4.0% or less since the spring of 2018. As at March 2019, core Consumer Price Index (CPI) was 0.8% in the euro area and 0.3% in Japan.

West Texas Intermediate (WTI) **oil prices** have been very volatile since late October 2018, falling from a relatively stable US$70 in the May–October period to about US$45 at the end of 2018, before rising to nearly US$65 by mid-April 2019, and then receding to below US$60 by the end of May. The initial fall in prices mostly reflected U.S. waivers on imports of Iranian oil and a large increase in global production, notably shale oil in the United States, but it also reflected weakening global growth toward the end of the year. The subsequent recovery stemmed from production cuts by Organization of the Petroleum Exporting Countries (OPEC) and non-OPEC countries and from unplanned outages (e.g., Russian pipeline to Europe). Meanwhile, the price discount to WTI on Western Canada Select oil has shrunk from a record US$50 in October 2018 to a more normal US$15 in May 2019. Contributing to this reduced discount were production cuts totaling 325,000 barrels a day mandated by the Alberta government in January, due to be curtailed to 175,000 barrels a day in June, and 95,000 barrels a day by December.

Global Economic Outlook

We continue to believe that businesses should base their plans on projected 3.3% annual global growth over the next three years (i.e., growth near potential but somewhat weaker than the above-potential growth of 3.7% in both 2017 and 2018). In China further rebalancing of the economy and trade restrictions and uncertainties would slow growth, but only gradually overall as easing of fiscal and monetary policies would provide an offset. In the United States the fading impetus of the end-of-2017 tax and fiscal stimulus, combined with trade restrictions and uncertainties, would contribute to reduce the unsustainably high growth rates of 2017 and 2018 to the potential rate. Monetary policy should remain accommodative.

Table 1.1

SHORT-TERM PROSPECTS FOR OUTPUT GROWTH (%)*

	2018 World Output Share (%)[2]	2018	2019	2020	2021
Canada	1.4	1.8	1.3(2.0)	1.9 (1.8)	1.9(1.7)
United States	15.2	2.9	2.5(2.5)	1.9 (1.8)	1.8(1.8)
Euro Area	11.4	1.8	1.3(1.6)	1.5(1.7)	1.5(1.5)
Japan	4.2	0.8	0.7(0.9)	0.5(0.3)	0.5(0.5)
Advanced economies[1]	32.2	2.2	1.8(2.0)	1.6(1.6)	1.5(1.5)
China	18.7	6.6	6.2(6.2)	6.0(6.0)	5.8(5.8)
India	7.7	7.1	7.3(7.5)	7.5(7.5)	7.5(7.5)
Rest of World	41.4	3.0	2.5(2.8)	2.8(2.8)	2.8(2.8)
World	100	3.7	3.3(3.5)	3.4(3.4)	3.3(3.3)

* Figures in brackets are from the *Bennett Jones Fall 2018 Economic Outlook*.

[1] Weighted average of Canada, United States, euro area and Japan.

[2] Shares of world output are on a purchasing-power-parity basis.

Section I: Global Growth to 2021

Much as in our *Bennett Jones Fall 2018 Outlook*, we project the world economy to grow at about its potential rate of 3.3% over the next three years (Table 1.1). This is significantly slower than the 3.7% pace recorded in 2017 and 2018 when advanced economies were growing faster than potential and economic slack was rapidly absorbed. The projected slowdown largely originates in the advanced economies, which now operate at or near capacity, and to a lesser extent in China. Going forward, potential growth in the advanced economies is expected to be held back by a continuation of the modest labour productivity growth experienced in the last several years and by the negative impact of population aging on labour force growth.[1] Meanwhile, aggregate demand growth in the advanced economies will be driven down to its lower potential rate primarily due to the run-off of the effects of the 2018 U.S. fiscal policy stimulus, and the negative effects of past normalization of U.S. monetary policy, and past appreciation of the U.S. dollar. While there will be some drag exerted in the short run by U.S. and Chinese tariff increases through their effects on trade and domestic demand, we look through these short-run effects and assume that there will be no major ongoing disruptions to global trade volumes. The global slowing nevertheless will likely be accentuated by ongoing political issues in Europe.

We do not think that the known global economic and financial headwinds are sufficiently severe in and of themselves to cause a recession in advanced economies over the next couple of years. In China, expansionary fiscal and monetary policies are likely to be used to support domestic growth, with positive spillovers on global growth and commodity prices. Central banks in advanced economies have indicated they will show flexibility in the path to normalization, as long as economic prospects remain highly uncertain and inflation subdued. Moreover, fiscal policy is likely to move in a more expansionary direction in some advanced economies, providing further offset to trade and other headwinds.

As in our previous outlooks, we assume that the **WTI oil price** will fluctuate around US$60-65 per barrel in the short term. For planning purposes we think it is useful to assume that world oil supply will adjust to changes in demand over time so as to keep prices a little over US$60 on average. However, we anticipate much volatility around that level in reaction to industry news, geopolitical developments, revised economic forecasts, and delayed adjustment of oil supply to changes in demand.

Regarding other commodity prices taken as a whole, we adhere to the International Monetary Fund (IMF) view of a subdued outlook in the short term.

The **U.S.-China trade dispute** has intensified lately: on May 10, the U.S. administration increased the 10.0% tariff on $200 billion worth of imports from China to 25.0% and signaled its intent to impose a 25.0% tariff on all remaining U.S. imports from China, about $300 billion. China retaliated by announcing it would raise tariffs up to 25.0% for most of the goods on its $60-billion list starting June 1, 2019. As a first approximation, these tariff increases, if maintained, might reduce the level of real U.S. GDP by 0.3–0.4% by the end of 2020; these effects are already incorporated in our outlook. The impact on China's GDP is estimated to be larger than on the U.S. GDP. We have not incorporated the impact of any further trade actions in our projection and make no allowance either for the deleterious effects of these further actions on business and consumer confidence or for any offsetting easing in monetary or fiscal policy in reaction to these actions.

Our projection assumes that the United States and China will conclude some form of agreement before the U.S. presidential election, without in the meantime triggering a full-blown trade war. Their economies will be impacted in the next several quarters by the effects of the implemented tariff increases but, as discussed below, macro policies will provide an offset and smooth the path toward potential growth by late 2020.

Besides the U.S.-China trade dispute, the U.S. administration has threatened to impose a 25.0% tariff on imported cars and parts from the European Union (EU) and Japan on national security grounds. In May, President Trump decided to wait up to six months before determining to impose such a tariff, which would have material consequences not only for the EU and Japan, but also for the United States. Our projection is based on our view that this tariff is unlikely to be applied in the future.

Similarly, we assume that the U.S. will not actually implement Mr. Trump's recent threat to raise tariffs on Mexico in response to the migration issue.

U.S. growth is projected to decelerate from an unsustainable 2.9% rate in 2018 to 2.5% in 2019, 1.9% in 2020 and 1.8% in 2021. Growth in aggregate demand falls to its potential rate of about 1.8% as the economy adjusts to: (i) the negative impact of increased trade barriers through trade, investment and cost increases; (ii) a run-off of the effect of the recent fiscal stimulus; (iii) past increases in interest rates; and (iv) past appreciation of the U.S. dollar. Exports, non-residential business investment and household consumption should all contribute to the slowdown. In the remainder of 2019, inventory investment is likely to decline and dampen growth.

U.S. price inflation has remained surprisingly tame so far in 2019 in the face of a very tight labour market and earlier tariff increases on imports from China, a development that the Federal Reserve attributes at least in part to temporary factors. While we still subscribe to the Federal Reserve's view that inflationary pressures will soon materialize, we expect that U.S. inflation will remain contained in the short term as the economy decelerates markedly and inflation expectations centered on the 2.0% target hold firm. Barring the implementation of the further tariff increases currently contemplated by the U.S. administration, cost-push inflation from tariff increases should also remain limited. Thus, a burst of inflation has a low probability of occurring later in 2019. Correspondingly, we attach a low probability to a rise of more than 25 or 50 basis points in the U.S. policy interest rate over the projection horizon. The recent escalation of the trade dispute with China and persisting subdued inflation leave little room for interest rate increases in 2019, whereas we anticipated a 100 basis points increase in our fall outlook. In contrast with the recent prevailing view reflected in financial markets, however, we do not expect that the Federal Reserve will significantly reduce its policy rate as the unemployment rate is expected to remain low, and growth to remain above or at potential going forward. For planning purposes, businesses should assume a very modest increase in Treasury bond rates by 2021.

Euro area growth is projected to fall from 1.8% in 2018, to 1.3% in 2019 and 1.5% in 2020 and 2021. Weighing on euro area growth going forward are slower global demand growth, low confidence as well as political uncertainty as some of the headwinds created by Brexit, fiscal challenges in Italy and protests in France should continue to hamper activity. Nevertheless, our projection cannot rule out a no-deal Brexit, which would have a negative effect on EU growth in the short term. On the other hand, the negative impact of changes in emissions regulation in the car industry in 2018 will disappear. More importantly, the euro economy is likely to get support from fiscal easing in Germany and perhaps also France in reaction to "gilets jaunes", from still high growth of demand in China, and from an accommodating monetary policy from the ECB. Last March, the ECB signaled a shift toward more expansionary policy by announcing that policy rates would remain unchanged at least until the end of 2019, instead of mid-year, and that the expiring targeted longer-term refinancing operations would be replaced by new ones later in 2019.

Our projection for **Japan** calls for growth rates of 0.7% in 2019 and 0.5% in 2020 and 2021. This is similar on average to our fall outlook, reflecting the offsetting influences of more trade-related weakness in 2019 and the positive impact of new fiscal measures to mitigate the effect in 2020 of the planned consumption tax rate increase in October 2019.

As in our fall outlook, we project growth in **China** to fall from 6.6% in 2018, to 6.2% in 2019, 6.0% in 2020 and 5.8% in 2021. This gradual slowing reflects a natural downward adjustment as the structure of the economy shifts in support of consumption and housing-led growth and away from investment and exports-led growth. Tariff increases by the United States have become more severe since last fall, but Chinese authorities have eased both fiscal and monetary policies to counteract the loss of momentum in the economy. They have the capacity and have expressed their willingness to support economic growth in the face of headwinds going forward, even if this raises already high debt levels and hampers the rebalancing of the economy. As a result, projected growth decelerates at a measured pace over the next three years, although in 2019 the slowing is more rapid as the effect of U.S. tariff increases are increasingly felt.

We expect slowing growth in China and large advanced economies, and flat or declining real commodity prices to hold back growth in the **rest of the world**. Country-specific factors also importantly shape growth. Turkey and Argentina, for instance, should experience a contraction of activity in 2019 but rebound in 2020. India should see an acceleration of growth in the next two years, especially in view of the results of the latest national election. Growth in Brazil is expected to pick up markedly from the low rates experienced in 2017 and 2018. On balance, growth in the rest of the world slows in 2019 but settles at a higher pace in 2020 and 2021.

Risks to the Global Outlook

We see three possible **upside risks** to our projection.

First, growth in China could be somewhat stronger than we envisage if authorities show more readiness than we expect in keeping growth at or close to their official target of 6.5%, instead of letting it drift lower. This would have positive spillovers on global growth and commodity prices.

Second, we see the risk of a burst of inflation in 2019 as low and therefore the risk of a significant escalation of U.S. interest rates as equally low. In fact, U.S. inflation may remain significantly below target instead of eventually responding to demand pressures and cost increases as we expect in our projection. This could incite the Federal Reserve to reverse monetary policy normalization, thereby providing more support to growth.

Third, discretionary U.S. fiscal policy may turn expansionary in advance of the presidential election in 2020 and keep growth above instead of at potential for a short while.

There are four specific **downside risks** to our short-term outlook that we want to flag besides geopolitical risks related to Arab countries, Russia, or Asia (the Korean Peninsula and South China Seas).

The first and biggest downside risk is that the U.S.-China trade dispute degenerates into a full-blown trade war. The hit to global growth would be considerable especially to the extent that uncertainty soars, confidence plummets, and a major sell-off in markets tightens financial conditions. In addition, there remains the risk that the U.S. administration may decide to actually impose a 25.0% tariff on imported cars and parts from the European Union and Japan at the end of the current six-month grace period. This would have a material effect on the three economies.

Second, there is a risk that the United States will carry out Trump's threat to place a tariff on imports from Mexico if Mexico does not take action to restrain migration to the United States.

Third, a no-deal Brexit may well emerge instead of a soft Brexit as assumed. This would disrupt supply chains and raise trade costs with potentially large and persistent negative impacts on the U.K. and EU economies.

Finally, it is hard to judge how far a conflict between the U.S. and Iran could go beyond the recent U.S. decision to end import waivers for Iranian oil. The risk of a temporary escalation of world oil prices and consequent negative effect on global growth in the short term cannot be ruled out.

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Section II:

International Trade

The overall situation in international trade remains similar to what we described in our *Bennett Jones Fall 2018 Economic Outlook*. Uncertainty continues to be the most apt description of what we see. However, there have been a few positive developments which are described in our report. At the global level, the scene is dominated by the U.S.-China trade frictions which have intensified in recent weeks. Efforts continue between these two countries to resolve their differences. However, any honest appraisal needs to recognize that this trade feud is part of a larger strategic struggle over which country will be the dominant power in the 21st century. There may be a temporary respite in the trade spat but it almost certainly will not resolve the larger issue and tensions will remain at an elevated level for a considerable period of time. Indeed, there are signs that the Trump administration may be doubling down on dealing with China by removing irritants with key allies. The decision by President Trump to delay for six months, a final determination on whether to apply duties on automobile imports into the United States for alleged national security reasons under Section 232, will take some of the heat out of U.S.-EU and U.S.-Japan relations. Similarly, the agreement with Canada and Mexico to terminate the Section 232 tariffs on steel and aluminum improves U.S. relations with its two North American partners.

The Canada-United States-Mexico Agreement (CUSMA),[2] the president's signature trade policy success, awaits action by Congress. There is a lack of enthusiasm for the agreement but both Democrats and Republicans have been careful to leave the door open to eventual ratification. For the administration securing ratification of this agreement is critical. In testimony in February to the Ways and Means Committee of the House of Representatives USTR Lighthizer said "there is no trade program in the United States if we don't pass the [CUSMA]".

Meanwhile, push back in Congress and the country to the president's aggressive trade policy continues to build as it becomes apparent that President Trump's March 2018 tweet that "trade wars are good, and easy to win" is not an accurate reflection of reality. Perhaps we are witnessing an evolution in U.S. trade policy to prioritize objectives and to try actually working with partners.

The president's withdrawal from the Trans-Pacific Partnership agreement (TPP), and the lack of progress in engaging in free trade negotiations with the EU means American exporters are suffering from self-inflicted Least Favoured Nation treatment. Ambassador Lighthizer has now engaged in free trade negotiations with Japan but following President Trump's trip to Japan it is now clear a deal cannot be concluded before August at the earliest. Time is running out for the administration to conclude major trade agreements before the 2020 election, particularly with an agenda which already includes getting the United States-Mexico-Canada-Agreement (USMCA) through Congress and striking a trade deal with China. It should also be noted that the Trade Promotion Authority, by which Congress delegated authority to the president to negotiate trade agreements, expires on July 1, 2021, just five months after the next presidential inauguration. This picture is deeply worrying for world-class American businesses including agricultural producers who are prominent in Trump's base.

At the WTO the United States continues to maintain its refusal to consider the appointment of new members to the WTO Appellate Body, but their overall approach in the WTO appears less strident than a year ago. The United States recently scored a major victory in the WTO when a panel ruled that Chinese domestic support for wheat and rice exceeded what China is allowed to do by nearly $100 billion per year.[3] The panel report was subsequently adopted by the WTO Dispute Settlement

Body when neither side appealed the ruling to the Appellate Body. In January, 76 WTO members announced their intention to commence WTO negotiations on trade-related aspects of electronic commerce.[4] There is growing evidence that many WTO members are interested in making progress on WTO reform. Jim Carr, Minister of International Trade Diversification, convened the third ministerial meeting of the Ottawa Group on WTO reform in the week of May 20 on the margins of the Organisation for Economic Co-operation and Development (OECD) Ministerial Council meeting in Paris. On May 13 and 14 in New Delhi, India, convened a meeting of ministers from 16 developing and 6 least developed countries to discuss WTO reform issues. China has announced its intention to host a similar conference in the fall of 2019 in China and has circulated a paper on WTO reform. The last time there was such ministerial involvement in discussing multilateral trade issues was in the 1980s, in the years preceding the launch of the Uruguay Round of General Agreement on Tariffs and Trade (GATT) negotiations which led to the formation of the WTO.

A strong WTO is of great importance to Canada because it establishes an international body of rules that provides, and usually ensures, equal treatment for small, medium and large countries. Without the WTO, and with major powers focused on managing their own problems, Canada would be faced with a very uncertain trading environment. It is in Canada's national interest to work with other small- and medium-sized countries to contribute to a revitalization of the WTO. If the WTO unraveled, we would find out quickly just how important it is for Canadian interests. There are many rules such as those dealing with anti-dumping, countervailing duties and subsidies that are only dealt with at the WTO. All the bilateral and plurilateral trade agreements are grounded in the foundations of the WTO. Furthermore, WTO dispute settlement has been vital in protecting Canadian rights in a way that bilateral dispute settlement arrangements never have.

For Canada, stabilizing trade relations within North America remains job one. The fate of CUSMA lies in the hands of the American Congress because the prospects for ratification are much greater in Canada and Mexico. The agreement announced on May 17 to remove American duties on steel and aluminum imports from Canada and Mexico, creates a more positive environment in all three countries for considering the ratification of the CUSMA.

The second most important thing for Canada is to take advantage of the preferential access we now enjoy as a result of the coming into force of the Comprehensive and Progressive Agreement on Trans-Pacific Partnership (CPTPP) and the Comprehensive Economic and Trade Agreement (CETA) with the EU. With the Americans having counted themselves out, this is a once in a century opportunity to make inroads into these markets and to consolidate our position.

Third, we need to take stock of our relationship with China and how best to manage it going forward. Clearly that will not be easy as recent history has demonstrated. We need to conduct a hard-nosed assessment of the challenges in China and it should start with an appraisal of Chinese economic fundamentals that needs to underpin the subsequent policy analysis.

Overall, we believe that Canada has already negotiated trade agreements that provide major opportunities for Canadian business and producers. The government should now concentrate its resources on helping the private sector take advantage of these opportunities rather than pursue the negotiation of additional trade agreements with countries whose markets offer relatively fewer opportunities.

Trump's Trade Policy in Year Three

Donald Trump boasts of the successes of his America First trade policy but it is hard to see where there are any real gains—unless the real objective is decoupling of the U.S. and Chinese economies and simultaneously isolating the United States from its traditional trade partners. His biggest success is the renegotiation of the NAFTA, but that cannot be chalked up as a victory until he secures Congressional approval. Of course, he can also tout the tweaking of the trade agreement with South Korea as a success, but that hardly constitutes a remaking of the American trade relationship with the world.

His approach to rebalancing the relationship with China is not going well. The threats continue as Trump's tweets make clear. On May 5, he tweeted:

"For 10 months, China has been paying Tariffs to the USA of 25% on 50 Billion Dollars of High Tech, and 10% on 200 Billion Dollars of other goods. These payments are partially responsible for our great economic results. The 10% will go up to 25% on Friday. 325 Billions Dollars....

....of additional goods sent to us by China remain untaxed, but will be shortly, at a rate of 25%. The Tariffs paid to the USA have had little impact on product cost, mostly borne by China. The Trade Deal with China continues, but too slowly, as they attempt to renegotiate. No!"

This approach would effectively penalize all of China's exports to the United States and has already incurred retaliation from China.

President Trump has noted that in a tariff war the United States has more ammunition because they have a large trade deficit with China. However, there are other economic retaliatory tools the Chinese government can use including:

- tightening the screws on American companies operating in China through the use of various regulatory measures;
- making it harder for American businesspeople to travel to China;
- reducing trade barriers and other restrictions for non-American companies and investors to weaken the competitive position of American firms in the Chinese market place; and
- encouraging the Chinese people to boycott American products.

On May 15, President Donald Trump signed the "Executive Order on Securing the Information and Communications Technology and Services Supply Chain".[5] The Order finds "that foreign adversaries are increasingly creating and exploiting vulnerabilities in information and communications technology and services." It authorizes U.S. government agencies to take a wide range of actions to thwart this threat. The Order makes it very difficult for Huawei to conduct business with any U.S. entity. This action may encourage the Chinese to think of other ways to hit back.

American tariffs on steel and aluminum have resulted in a self-inflicted injury rather than a rejuvenation of the American economy.

The promised bilateral agreements with countries like Japan after withdrawal from the TPP have yet to be realized.

A free trade agreement with the EU seems a long distance off.

If this situation is successful, do not tell the beleaguered farmers and other producers suffering from higher import costs and reduced export opportunities. In Section I of this outlook, we consider the effect of the U.S.-China trade dispute on GDP in the United States and China. Our estimates are that the effect would be in the order of 0.3 to 0.8% of GDP in the United States depending on how far Trump goes in imposing more tariffs. However, the effects will not be spread evenly with, for instance, farmers in Trump's base being impacted much more significantly.

World Trade Organization

Amidst significant trade tensions and very challenging times for global trade, there is reason for muted optimism about the WTO and the rules-based trading system that it promotes. This is because WTO members are actively pursuing a WTO reform agenda so that the organization will be better placed to respond to the world economy as it undergoes a technological transformation. Members have also agreed to commence negotiations on trade-related aspects of electronic commerce, an increasingly important aspect of today's economy but until now, a subject-area on which members could not agree to focus attention. Finally, although the deadlock in appointing new judges to the WTO Appellate Body has not been resolved, members continue to rely regularly on the WTO dispute settlement mechanism to resolve trade disputes, a testament to the continuing confidence members have that the mechanism is capable of providing fair and impartial resolutions to serious trade irritants.

WTO Reform Agenda

The WTO has embarked on a critical reform agenda as it approaches its 25th anniversary next year. There is no single impetus for this reform movement—several factors likely contributed. These include technological advances that are revolutionizing the way we trade: WTO rules must be updated to address new areas, such as digital trade. In addition, perceptions that WTO rules are inadequate to resolve recent trade tensions between the United States and China have prompted some members to work on crafting new disciplines on non-market oriented policies and practices. WTO negotiations on eliminating harmful fisheries subsidies that lead to overcapacity and overfishing, set to conclude at the end of this year, respond at least in part to the United Nations (UN) Sustainable Development Goals. Finally, the United States' continued refusal to permit appointments to the WTO Appellate Body has frustrated a number of WTO members but it has also led several of them to propose amendments to the system with a view to responding to what they consider are legitimate U.S. concerns.

As reported in our fall economic update, Canadian Minister for International Trade Diversification, Jim Carr, established what has become known as the Ottawa Group, 13 WTO members working to strengthen and modernize the WTO. Following an inaugural meeting held in Ottawa last October, the group has met on two more occasions—in January in Davos, and in May in Paris. The group's current focus is on improving the deliberative function of WTO bodies. Australia, Brazil, Singapore and Switzerland are leading reviews on four WTO bodies (the Council for Trade in Services, the Sanitary and Phytosanitary Measures Committee, the Technical Barriers to Trade Committee and the Rules of Origin Committee), while Norway is coordinating efforts on developing country issues as they affect WTO reform.

Reform efforts are also underway outside the Ottawa Group process. As mentioned above, India recently hosted an informal Ministerial meeting attended by several developing country ministers, and China will host a Ministerial-level meeting later this year. The EU, Japan and the United States are collaborating to develop rules on state support of industries (industrial subsidies) and state-owned enterprises. Several WTO members have distributed papers outlining overall positions on reform. For example, Canada, China and the European Union have each issued concept papers touching on several areas, including on rule-making procedures (e.g., consensus, multilateral, plurilateral), improving the capacity and opportunity for deliberation, enhancing opportunities within WTO committees to address specific trade concerns, and mechanisms to take provisional remedies in cases of urgency. Fifty-nine members (counting the European Union as 28) have contributed reform proposals touching on three main themes: (i) procedures to strengthen notification requirements so that there is more transparency when members adopt subsidies, domestic support and other measures; (ii) development issues, including the relevance of special and differential treatment in favour of developing members to promote development and whether the binary construct of developed versus developing status is outdated and undermines WTO negotiations; and (iii) the functioning of the Appellate Body, addressing a variety of concerns raised by the United States during several meetings of the WTO Dispute Settlement Body, including judicial overreach, advisory opinions, Appellate Body reports as precedent, treatment of municipal law as fact and respect for timelines.

Appellate Body reform is the subject of most of the proposals. This reflects the urgency to find a solution to the impasse on appointing judges to the Appellate Body to replace those whose terms have expired. If no new appointments are made by December of this year, the Appellate Body will not have the requisite three members to hear an appeal. Earlier this year, no doubt in recognition of the importance of finding a resolution to the impasse, the WTO General Council, the highest-level WTO governing body composed of all 164 WTO members, appointed Ambassador David Walker of New Zealand to facilitate discussions on Appellate Body reform.

WTO reform is also receiving a lot of high-level attention outside its corridors. United Nations Secretary General Antonio Guterres addressed the organization on May 10 and underscored the importance of revitalizing multilateral trade cooperation and the need to "buttress this unique institution ... that has safeguarded international trading relationships over the past 70 years."[6] In December 2018, G-20 leaders observed that the WTO system is "currently falling short of its objectives" and supported "the necessary reform of the WTO to improve its functioning."[7] Similarly, the

Asia-Pacific Economic Cooperation (APEC) Ministers responsible for trade agreed in May 2019 that "action is necessary to improve [the WTO's] functioning."[8]

Heightened activity on WTO reform does not guarantee quick or certain results. Members' perspectives on development issues, for example, are far apart, and progress on Appellate Body reform is far from guaranteed. However, the fact that real and significant reform discussions are underway among WTO members and that the UN, the G20 and APEC support WTO reform efforts illustrates what the WTO Director-General recently described as "a real shift in tone" and a genuine opportunity to update the global trading system.[9] This shift is a positive development for the WTO, and for the rules-based trading system

Electronic Commerce

Negotiations on trade-related aspects of electronic commerce were launched earlier this year. Seventy-seven WTO members, including Canada, the United States, China, Japan, EU, Australia, Brazil, Singapore, Russia and several developing countries, are participating in the discussions. Issues raised include whether or not to continue a long-standing moratorium on customs duties on electronic transmissions, facilitation of e-commerce transactions, paperless trading and e-payments. Discussions also address issues related to market access for goods and services, data flows across borders, protection of consumer and personal data, digital security and the need to address the digital divide. The Canadian government sought input from interested stakeholders regarding these and other subjects that could form part of the discussions, which will inform the development of its own position.[10]

Although e-commerce has long been on the WTO agenda, progress was blocked until December 2017, when 71 members announced a joint initiative to initiate exploratory work toward future negotiations. Talks are progressing and include written proposals from the United States, EU (including draft text) and China. Positions differ in significant ways, but unlike in the past, this has not resulted in a stalemate on moving forward. This is significant, not only because technological advances are revolutionizing the way we trade and therefore WTO rules must be updated to deal with them. It also demonstrates that members are willing and able to proceed with negotiations on a plurilateral basis and that the consensus model that hampered many efforts in the past may no longer hold sway. This, too, is a positive development for the WTO, and for the rules-based trading system.

WTO Dispute Settlement Mechanism

The WTO dispute settlement system has always been busy. Close to 600 disputes have been filed since 1995 and the number of active disputes ongoing at any time has been rising each year. Thirty-eight new disputes were filed in 2018, and 10 appeals were filed. So far this year, 10 new disputes were filed, as were 2 appeals. There are currently 12 appeals before the Appellate Body, 3 of which were filed by the United States.

These statistics seem to belie what many have referred to as a crisis in the WTO dispute settlement system. Despite the increasing likelihood that the Appellate Body will no longer be able to receive new appeals by December of this year, because the number of judges will be reduced to one (and three are needed to sit on any appeal), developed and developing country members continue to rely on the WTO to resolve their trade disputes. In fact, some members have agreed in writing at the commencement of dispute settlement procedures that if the Appellate Body is composed of less than three members on the date of circulation of the panel report, they will not appeal the report. This is especially significant given that the rate of appeal of panel reports has traditionally been very high (on average, 70.0% per year). We see members' continued willingness to resort to the WTO dispute settlement mechanism, flawed as they consider it to be, as very positive for the WTO. It is also indicative of the fact that the WTO offers the only viable mechanism to resolve major international trade disputes between states.

In sum, we are encouraged by the reform effort and applaud Canada's leadership in this vein. These efforts must be sustained, however, in order to achieve meaningful results.

Brexit

Another factor in creating uncertainty in international trade and economic relations is Brexit. It remains unclear exactly how this saga will end or when. Prime Minister May's premiership has been destroyed by her failure to develop a plan to take Britain out of the EU that could command a majority in Parliament. The credibility of Britain's two main parties has been undermined in the process. The Union itself may be in jeopardy. And yet despite the difficulties of agreeing on how to leave the EU the biggest challenge still lies ahead—determining the nature of the future relationship between the United Kingdom (UK) and the EU. That should be a major focus of attention in the coming months. A better understanding of the challenges of how to fashion that relationship to benefit UK national interest might well facilitate better final decisions on how to leave the EU, or to abandon the project altogether.

The Trade World Through Canadian Eyes

Prospects for CUSMA

As noted above, the prospects for ratification of the CUSMA have been improved by the agreement to remove the Section 232 tariffs on steel and aluminum. Key Congressional leaders had made it clear that this was an essential step to ratifying the agreement. Of course, Canada and Mexico also agreed to remove the counter tariffs which they had imposed in retaliation for the U.S. action. What is less obvious in the reporting is that, as the Americans point out in their May 17 press release,[11] "the agreement provides for aggressive monitoring and a mechanism to prevent surges in imports of steel and aluminum. If surges in imports of specific steel and aluminum products occur, the United States may reimpose Section 232 tariffs on those products." In the agreement, Canada has undertaken to "prevent the importation of aluminum and steel that is unfairly subsidized and/or sold at dumped prices" and "to prevent the transshipment of aluminum and steel made outside of Canada or the United States to the other country." It is not clear how these objectives will be realized. It is not unlikely that difficult bilateral discussions still lie ahead, although it is to be hoped that the Americans would not readily reimpose these tariffs.

On May 29, Canada began the formal process to ratify the CUSMA when Prime Minister Trudeau introduced in the House of Commons Bill C-100, An Act to implement the Agreement between Canada, the United States of America and the United Mexican States.[12] The government has indicated that Canada will proceed in tandem with the United States and Mexico in implementing CUSMA, suggesting that Canada will not complete the legislative process until the United States is also well engaged. Of course, little time is left for new parliamentary business before the fall election.

Clearly this move is not unrelated to Vice President Pence's visit to Ottawa on May 30. Pence has been traveling in the United States, to extoll the benefits of the new agreement and to build support for its ratification in Congress. He and the Prime Minister compared notes on the prospects for ratification and on how to build momentum to help get the new North American Free Trade Agreement (NAFTA) ratified in three countries. Movement by Canada may serve as a useful example for the administration as it tries to persuade the Democrats to get on board. In addition, by moving forward in this way the government may well encounter less pressure from the Americans to tweak the Canadian legislative proposals than would be the case if the Americans had already got the deal through Congress. It is worth noting that the Mulroney government put the NAFTA implementing legislation through Parliament while the side agreement negotiations on labour and environment were still underway.

Certainly securing Congressional ratification of CUSMA is a big deal for the Trump administration. U.S. Trade Representative Robert Lighthizer's testimony to the House Ways & Means Committee on February 27, 2019, is definitive on that score:

"There is no trade program in the United States if we don't pass the [U.S.-Mexico-Canada Agreement]... If the Congress doesn't see fit to pass that, then everything else is kind of like a footnote. We can't do trade deals. What it says is that we don't have a consensus and that we don't want to stand up for our workers and our farmers and our ranchers. "We have an agreement that is clearly better than its predecessor... It's $1.3 trillion worth of business—millions and millions of people are affected and it just has to pass."[13]

The President's threat to apply import duties to all Mexican products as a result of his concerns about migration from Mexico underlines the unpredictability of his approach to trade. However, in our view it is unlikely that duties will actually be applied in large part because of the serious negative reaction to his proposal inside the United States notably from leading Republicans in Congress.

Whether it is possible for the administration to secure Congressional approval before the 2020 American election is unclear. There does not seem to be great enthusiasm in Congress, particularly among Democrats, to take this on at this time. But it is noteworthy that the Democrats have been careful in what they have said about the new agreement. Putting it into law has not been ruled out of hand. Interestingly, the proposals for change that have been identified by Democrats probably pose greater problems for Republicans than for Canada or Mexico. They seem to involve strengthening the dispute settlement provisions of the agreement and weakening the agreed protection for biologic drugs in the pharmaceutical area.

Under the terms of U.S. law, it is possible for the CUSMA to be considered by the next Congress pursuant to the current Trade Promotion Authority including its provisions for "fast track" treatment in Congress.

Making CPTPP and CETA Work for Canadians

As noted above, Canada now has preferences in Europe, Japan and other CPTPP markets that are not enjoyed by our American competitors. We should be moving now as a top priority to take advantage of these opportunities and to consolidate our position in those markets. It may be some years before the United States negotiates equivalent market access particularly in Europe. In Japan, our preferences may be eroded more quickly but even so we should work hard to ensure that Canada gets its share of benefits from the new liberalization of the Japanese market.

One challenge for Canadian businesses is identifying where exactly the new opportunities are. This requires people, perhaps from the private sector, who are knowledgeable about the trade dynamics of particular products, and who are prepared to spend time going through the tariff schedules. It may sound tedious but the payoffs could be very large indeed.

The government has already put considerable effort into assisting business to take advantage of the new market access but further effort now should pay dividends for years to come.

Managing Challenges in China

Canadians are learning quickly just how difficult it is to manage our trade relations with China when our dominant trading partner, the United States, is exchanging trade blows with China. Despite the difficulties we should not lose sight of the fact that China is our second largest trading partner and that it is an important market for many Canadian products, particularly in the agricultural sector.

The current furor concerning Canadian canola exports to China is a good starting point for thinking about how to proceed. The assumption in Canada has been that our canola exports have stopped because the Chinese government has decided to punish Canada for its arrest of Huawei executive Meng Wanzhou, pursuant to an American extradition request. This seems a reasonable assumption and is further bolstered by recent experience with Chinese restrictions on Canadian canola exports because of an alleged risk posed by a fungal infection called blackleg. If we look deeper into what is going on, we learn that according to a United States Department of Agriculture (USDA) report[14] African Swine Fever (ASF) is a game changer for global oilseed markets. ASF has resulted in a reported decline of 20.0% in the size of China's pig herd since August 2018. As a consequence, the USDA is forecasting an accumulated decline in China's import demand for soybeans of 42 million metric tons through 2019-20. Senior American officials are cautioning producers about relying on sales of soy and corn to China and recommending that instead, they focus on exporting meat and ethanol to that market.

It is relevant to note that oilseed products like canola and soy are crushed to make oil and meal. The meal is used as animal feed so that economics of the crushing industry in China are dramatically affected by the enormous reduction in the size of the swine herd.

While the effects of ASF are dramatic, it seems that the Chinese are also moving away from a pork supply model that relies on domestic hog production fed by imported feed grains to a model based on greater imports of pork meat to satisfy consumer demand. If what we are seeing is a fundamental shift in the economics of Chinese food production, getting the Chinese to remove disease-related restrictions on Canadian exports will at best only partially restore our markets for canola.

It is important to make an accurate diagnosis of the problem before deciding on our response. Perhaps Canadians should be looking at investing in oilseed crushing facilities in Canada, producing meal for Canadian livestock, exporting more meat to China and other markets, as well as oil under the new access gained in Japan and elsewhere as a result of the CPTPP. China is going to continue to be a major and growing importer of food and agricultural products. Canadians can expect to find significant opportunities in China over the coming years despite the current downturn in the relationship.

One final point on the “canola” file, the Chinese authorities are probably pleased that Canadians think that the decline in canola shipments is solely the result of Chinese retaliation rather than, also, the result of a fundamental change in market conditions. After all, they are trying to change Canadian behaviour.

Another lesson here is that we should try to avoid becoming too dependent on any one market for sales of a particular commodity. We are trying to diversify away from overdependence on the U.S. market. We should bear this in mind as we consider how best to develop our relations with China.

Conclusion

We consider that while the outlook for global trade remains uncertain, there are some developments which suggest that the fears of global trade disruption evident in the current behaviour of financial markets will prove to be overblown. In particular, we see a few positive developments which suggest a slight evolution in the trade policy approach of the Trump administration. The Trump administration has continued to focus on China but has made an effort to shore up its trade relations with traditional allies. Perhaps the difficulties faced by farmers and others with the effects on their livelihood of trade retaliation have played a role. These developments also underline once again the value of advocacy efforts that reach out to our natural allies in the United States.

Section III:
Canadian Outlook

Recent Developments

Growth in Canada was only 0.4% at an annual rate in both 2018Q4 and 2019Q1, its slowest pace since 2016Q2. In 2019Q1, growth continued to be depressed by weakening housing and goods exports but household consumption and business non-residential fixed investment rose sharply. Moreover, there was a substantial rebound of real GDP growth in March, with gains widespread across industrial sectors.

Core CPI inflation has continued to be at, or close to, 2.0% in the first four months of 2019, consistent with an economy not far from capacity and inflation expectations solidly anchored at 2.0%. Various indicators of average wage rate showed only modest yearly growth rates at the beginning of 2019. The Bank of Canada has kept its policy interest rate at 1.75% since October 2018. On a monthly basis, the Canadian dollar has remained near 75 U.S. cents since mid-2018.

Prospects to 2021

The profile of Canadian growth to 2021 has changed since our fall outlook. Whereas previously, Canadian growth was projected to gradually slow toward its potential rate starting in 2019, in the current projection growth falls below potential in 2019, but rises slightly above potential in 2020 and 2021. Thus real GDP growth decelerates to 1.3% in 2019, from 1.8% in 2018, before rebounding to 1.9% in both 2020 and 2021 (Table 1.1).

Many economies experienced a slowdown in 2018Q4 against a background of high trade uncertainty, tighter financial conditions and political headwinds, but in Canada the deceleration was more severe than elsewhere primarily because of a substantial drop in the price of Western Canadian oil. This shock has depressed Canadian real national income, employment and investment in the oil and gas sector and related industries and household spending in oil-producing provinces. Excess capacity re-emerged in 2018Q4 and has increased in 2019Q1. From a relatively weak position in early 2019, the Canadian economy is expected to gradually gain momentum, leading to above-potential growth by 2020. To a considerable extent the projected gain in momentum stems from a fading of the negative effects that have weighted on the economy recently. Thus, to quote the Bank of Canada in its April 2019 Monetary Policy Report (p.9), "The dampening effects on growth of low oil prices, changes to housing policies and the 2017-18 increases in borrowing rates should dissipate over 2019". This would contribute to a stabilization of housing and a firming of household consumption. Growth in consumption is nevertheless expected to be moderate over the short term.

Besides the fading of negative factors, a number of positive developments should enhance Canadian growth going forward. Business investment outside the oil and gas sector would benefit from new tax changes by the federal, Ontario and Québec governments. Healthy growth in U.S. activity, rising production capacity in Canada, the assumed ratification of CUSMA, which would reduce trade uncertainty, and the projected alleviation of transportation constraint on shipments of Western Canadian oil through rail and pipeline expansion (assumed to be completed by the end of 2021), would provide support to growth in exports and investment. Exports of travel and commercial services should continue to grow at a robust pace.

Taken together the 2019 budgets (before reserve) of the federal, Québec, Ontario and B.C. governments provide no impulse to growth, either positive or negative, in 2019 (see Section IV, Table 4.1). Fiscal consolidation gives rise to negative impulses to growth of about 0.3% of GDP each year from 2020 to 2023. With the additional fiscal restraint to be expected in the next Alberta budget, the negative impulse to Canadian growth will probably reach 0.4% of Canadian GDP each year over the next four years, which means that Canadian real GDP growth could be cut by 0.2% to 0.4% in each of those years.

The Bank of Canada has made clear that monetary policy is "data dependent". Should the Canadian economy unfold as we and the Bank of Canada project,[15] then a cautious Bank of Canada would continue to keep its policy rate steady at 1.75% but move the policy rate toward 2.25%, the bottom of the neutral rate range, by 2021 as above-potential growth re-emerges. Raising the policy rate to its neutral level (2.25% to 3.25%)[16] would be consistent with keeping the economy at potential and inflation on target, going into the medium term.

Our assumptions concerning oil prices, growth and policy interest rates in the United States and Canada lead us to expect that the Canadian dollar will continue to move in a range near 75 U.S. cents in 2019. As in our fall outlook, the center of the band will tend to rise in the next two years to perhaps 78 U.S. cents by 2021. The expected expansion of crude oil exports as production and transportation capacities increase would provide support to the Canadian dollar.

Risks to the Canadian Outlook

The risks to our global outlook that were identified at the end of Section I represent risks to our Canadian outlook as well. A full-blown trade war between the United States and China would have grave consequences for global growth, trade and commodity prices, with important negative repercussions on Canada (see Section II on trade). Adverse global trade developments represent the biggest downside risk for the Canadian outlook. Bilateral issues with the United States and China also present some downside risk. However, stronger-than-expected U.S. growth would provide some offsetting upside risk to Canadian growth.

Our Canadian outlook is also at risk due to factors that apply more particularly to Canada. Housing may experience more weakness in the near term than implied by the soft landing implicit in our projection. This being said, downward price correction in large metropolitan markets would help improve housing affordability. Another risk is that the Western Canadian oil price may deviate more dramatically and persistently from the projected average price, thereby posing risks in either direction to Canadian growth. A related but negative risk to growth, particularly in Western Canada, would be that the coming on stream by 2021 of one or more of the three planned oil pipeline additions (Enbridge Line 3 replacement, Trans Mountain expansion and Keystone XL) be delayed, if not canceled. On the other hand, we may underestimate the stimulus to growth that the construction and operation of these pipelines would provide over the projection horizon. A final risk is the failure of the United States to ratify the USMCA followed by a possible break-up of NAFTA, contrary to our expectations. Canadian exports and investment would suffer as a result.

Section IV:
A Macro Perspective on 2019 Budgets

In this section we provide a brief analysis of 2019 budgets in Canada from a macro perspective. Earlier this year the federal, Québec, Ontario and B.C. governments released their 2019 budgets, which extend to 2021-22 for B.C. and 2023-24 for the others. The Alberta government has yet to come up with a new budget in 2019.

We begin our analysis by looking at the "consolidated" 2019 budget of the federal, Québec, Ontario and B.C. governments, for which we have hard data. Among other things, we assess how restrictive or stimulative the consolidated fiscal policy of these governments could be to Canadian economic growth over the next five years. We then analyze the 2019 budgetary projections of each of the four large jurisdictions separately and finish by discussing fiscal prospects for Alberta in anticipation of the next budget.

"Consolidated" 2019 Budgets

The 2019 budgets largely reflect the view that the United States and Canadian economies start growing at roughly their potential rates in the short term. Interest rates and bond yields are projected to rise slowly from current levels; the Canadian dollar is expected to strengthen steadily from near 75 U.S. cents in 2019 to 80 U.S. cents in 2023; and the WTI oil price is expected to rise from slightly below US$60 in 2019 to around US$65 in 2023. There are some differences in the profiles of these variables across the four 2019 budgets but, by and large, they are relatively minor.

Taken together, the 2019 budgets of the federal, Québec, Ontario and B.C. governments project own-source revenues to grow rather slowly in 2019-20 after an unexpectedly strong advance in 2018-19 (except in Ontario) and then to increase at nearly the same pace as Canadian nominal GDP over the next four years (Table 4.1). Program expenses increase at 2.5% per year through to 2023-24, a sharp slowdown from the accelerated pace of 2017-18 and 2018-19. This downshift can be found in all the four jurisdictions but is largest in Ontario. In contrast, public debt charges steadily increase relative to own-source revenue over the next five years even as net debt declines relative to Canadian GDP: this is due to a significant rise in the interest cost of new borrowing relative to that of maturing debt. The overall budget deficit before reserve reaches a peak of $23 billion or 1.0% of GDP in 2019-20 and steadily shrinks to zero by 2023-24. Net capital investments decline significantly over the next five years reflecting downward trends projected in the federal and Ontario budgets; in Québec and B.C. net capital investments significantly increase from their 2018-19 levels. Shrinking budget deficits and reduced net capital investments lead to a steady decline in the consolidated net debt relative to Canadian GDP.

Table 4.1

"CONSOLIDATED" 2019 BUDGETS BEFORE RESERVE OF FEDERAL, QUÉBEC, ONTARIO AND B.C. GOVERNMENTS

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Own-source revenue: % change	5.3	2.0	3.4	3.8	3.6	3.9
Program expenses: % change	5.3	2.1	2.6	2.4	2.6	2.7
Public debt charges: % of own-source revenue	8.0	8.4	8.6	8.7	8.8	8.8
Budget deficit before reserve ($ millions)	20,156	22,701	19,229	12,368	6,910	-142
Net capital investments ($ millions)	17,368	15,767	14,951	16,564	12,852	12,040
Net debt before reserve to Canadian GDP (%)	59.9	59.6	59.0	58.1	56.6	54.9
Fiscal impulse as % of Canadian GDP	0.1	0.0	-0.2	-0.3	-0.4	-0.3
Nominal GDP Canada: % change (fed)	3.8	3.4	3.5	3.7	3.9	4.0

In aggregate, the 2019 budgets of the federal, Québec, Ontario and B.C. governments pursue a program of fiscal consolidation founded on restraint in program spending growth and cuts in net capital investments. For 2019-20, these budgets (before reserve) taken together are neutral, generating no impulse to growth, either positive or negative. Fiscal restraint gives rise to negative impulses to growth of about 0.3% of GDP from 2020-21 to 2023-24 (Table 4.1), which means that Canadian real GDP growth could be cut by between 0.1% and 0.3% each year as a result. With the additional fiscal retrenchment to be expected in the next Alberta budget, the negative impulse to Canadian growth will probably reach 0.4% of Canadian GDP each year over the next four years. This means that **Canadian real GDP growth could be reduced by 0.2% to 0.4%, from what it might have been in each of those years as a result of budgetary policies.**

The 2019 Federal Budget

The federal government projects its total revenues to grow a bit slower than nominal GDP from 2019-20 to 2023-24, but only because of a temporary decline in corporate income taxes in 2019-20, reflecting temporary measures proposed in the fall update to stimulate investment (Table 4.2). At the same time, program expenses expand at a rate slightly inferior to population growth plus inflation, even as a substantial increase in the amount of direct fuel charge proceeds returned to the public in the context of the federal carbon pricing system boosts program spending growth by 0.3% per year.

Public debt charges increase rapidly as debt expands and borrowing costs rise. Overall, the budget deficit tops at $19.8 billion in 2019-20 and 2020-21 before shrinking to $9.8 billion by 2023-24, dragging down the accumulated deficit-to-GDP ratio to 28.6% in 2023-24 from 30.8% in 2018-19. The federal government also trims its net capital investments markedly relative to 2018-19, thus reinforcing, the negative impact of the deficit contraction on net debt.[17] Indeed, the net debt-to-GDP ratio falls to 32.2% in 2023-24 from 34.7% in 2018-19.

Table 4.2

FEDERAL GOVERNMENT: BUDGET 2019

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Total revenues (% changes)	6.7	2.0	3.7	4.4	3.8	3.9
Program expenses (% changes)	4.9	1.8	3.1	2.5	2.9	3.0
Public debt charges ($ millions)	23,600	26,200	28,500	30,200	31,400	33,200
Budget deficits ($ millions)	-14,900	-19,800	-19,700	-14,800	-12,100	-9,800
Net capital investments ($ millions)	4,000	2,600	2,600	2,800	2,100	1,500
Net debt-to-GDP ratio (%)	34.7	34.5	34.3	33.8	33.1	32.2
Accumulated deficit to GDP (%)	30.8	30.7	30.5	30.0	29.3	28.6
Canada nominal GDP (% changes)	3.8	3.4	3.5	3.7	3.9	4.0

Section IV: A Macro Perspective on 2019 Budgets

Earlier this year, we expressed the view that the federal Minister of Finance should take no spending or tax actions, which would further compromise a future government's room to take the necessary discretionary action to support growth and public investment in the event of a major economic downturn.[18] In fact, in its 2019 budget the federal government launched measures to stimulate housing and investment in the short term, which contributed to a significant expansion of the deficit and kept progress in reducing the debt ratio to a minimum. While the increased tax allowances for business investment rightly aimed at preserving Canada's tax competitiveness, the new initiatives to boost housing demand may not have been warranted in light of the already high levels of ownership rate and household debt in Canada. The federal government abstained from significantly strengthening its finances in the near term and hence will continue to have only modest fiscal room to provide economic stimulus in the event of a significant slowdown or recession. This slowdown could originate from weaker global activity due to trade wars or other factors (see Section I). It could also result from a combination of adverse domestic factors such as a major housing correction, weaker Western Canadian oil prices and bilateral trade issues as outlined in Section III. The planned or expected fiscal consolidation of governments from 2020-21 to 2023-24, if implemented, could reduce growth by as much as 0.4% per year after 2019.

As excess supply would grow rapidly as a result of an abrupt collapse of global demand, there would be great pressure on the federal government to provide fiscal stimulus to supplement the expected easing of policy rates by the Bank of Canada. To illustrate the implications of this situation, suppose that the Canadian nominal GDP turns flat in 2020 and that fiscal revenues automatically fall by about 3.0% in the year while program spending including some discretionary stimulus could increase by as much as 8.0%. These rates are half those experienced in 2009, at the worst of the Great Recession. The budget deficit (before reserve) in 2020-21 would more than double, to over $40 billion, and the net debt-to-GDP ratio (before reserve) would rise by about 2 points to about 36.3% instead of declining to 34.0% as budgeted. Even if the shock was to be completely reversed by 2023-24, in the sense that GDP, revenues and program spending get back to the same levels as in the base case by that year, the net debt-to-GDP ratio would still be higher than in the base case by 1 point in 2023-24 because over the years larger deficits would have accumulated into a larger debt. The important point to keep in mind is that even a temporary shock to GDP, revenues and spending has a permanent effect on debt. Of course the shock may be only partially reversed over time, in which case its impact on the debt ratio could be much greater.

The 2019 Québec Budget

In its 2019 budget, the government of Québec projects continued, moderate budget surpluses through to 2023-24 and a marked decline in its net-debt-GDP ratio from 40.0% in 2018-19 to 34.8% in 2023-24 (Table 4.3). On average, program expenses increase by 3.4% per annum from 2019-20 to 2023-24, significantly faster than the pace of inflation plus population growth. Own-source revenues grow at a slightly faster pace than nominal GDP in the last four years of the projection, but at a much slower rate in 2019-20 as corporate taxes and the school property tax temporarily decline in response to policy measures introduced earlier.

Table 4.3

QUÉBEC GOVERNMENT: BUDGET 2019

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Total revenues (% changes)	4.8	1.8	3.2	3.0	3.3	3.2
Program expenses (% changes)	5.1	5.0	3.3	3.0	3.0	3.0
Public debt charges ($ millions)	8,899	8,996	9,138	9,292	9,661	9,727
Budget surplus ($ millions)	5,606	2,504	2,684	2,947	3,360	4,032
Net capital investments ($ millions)	3,158	3,108	3,261	4,169	4,290	3,459
Net debt-to-GDP ratio (%)	40.0	38.8	37.7	36.8	35.9	34.8
Nominal GDP (% changes)	4.3	3.5	3.2	3.0	3.0	3.1

Section IV: A Macro Perspective on 2019 Budgets

As we surmised last February, the Québec government used the room provided by solid budget surpluses in previous years to lower tax rates and continue to increase program spending at a fast pace in 2019-20. The government scales down program spending growth in subsequent years, to a still solid rate, in order to maintain progress in reducing its debt ratio. Emulating the federal government, it introduced an enhanced capital cost allowance to foster business investment and keep its marginal effective tax rates for businesses highly competitive.

In its 2019 budget, the government reports that in the event of an average recession for Québec, the cumulative loss of own-source revenue relative to a base case would be $5.5 billion after the first two years and $8.1 billion after five years. Taking account of some increase in program spending as modest automatic stabilizers kick in, the negative impact of the downturn on the budget balance would be even greater, at least in the first two years. If such a downturn was to start in 2020-21, the projected steady surpluses in the current budget would turn into moderate deficits (before reserve). The net debt-to-GDP ratio (before reserve) would rise from 38.7% in 2019-20 to a peak of 40.7% in 2021-22 instead of falling to 36.8% in that year. By 2023-24 the debt ratio would be down to 38.8% instead of 34.7%. Thus, an average recession would severely hamper the objective of reducing the debt ratio, but in all likelihood would not jeopardize the high credit rating of Québec.

As we pointed out before, one key challenge for Québec is to raise potential growth in the economy. This would allow a reduction of the relatively high tax rates in the province and/or stronger program spending growth without compromising the debt reduction objective. The 2019 budget provides for initiatives to boost Québec's potential totaling $3.7 billion over the next five years, in addition to the measures announced last fall to stimulate business investment, including accelerated depreciation measures.

The 2019 Ontario Budget

In its 2019 budget, the new government of Ontario implemented the strategy it outlined last fall of eliminating the provincial deficit in five years through restraint on program-spending growth, while at the same time lowering taxes. The needed degree of restraint was eased somewhat by higher revenues, and hence a $2.8 billion smaller deficit for 2018-19 than what was expected in the Fall Economic Statement (FES). The 2019 budget proposes to restrain growth in program spending to 1.0% a year on average in order to eliminate the deficit (Table 4.4). It is based on the projection that revenues, both from own sources and federal transfers, grow at only 3.0% a year and that public debt charges increase by 4.3% a year with both debt and borrowing costs rising. The budget includes a $1.0 to $1.6 billion reserve each year. As will be discussed below the projected weak growth of revenues reflects unannounced tax cuts over 2021-22 to 2023-24. A sharply reduced deficit and a marked contraction of net capital investments first stabilize the net debt-to-GDP ratio at 40.7% in the short term and bring it down to 38.6% by 2023-24.

Table 4.4

ONTARIO GOVERNMENT: BUDGET 2019

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Total revenues (% changes)	0.1	2.3	3.6	2.4	2.9	3.9
Program expenses (% changes)	5.4	0.1	1.2	1.3	1.3	1.2
Public debt charges ($ millions)	12,534	13,335	13,700	14,400	14,900	15,500
Budget deficit ($ millions)	-11,736	-10,279	-6,800	-5,600	-3,500	300
Net capital investments ($ millions)	7,871	6,223	4,821	5,348	2,462	3,281
Net debt-to-GDP ratio (%)	40.2	40.7	40.7	40.6	39.8	38.6
Nominal GDP (% changes)	3.4	3.4	3.4	3.2	3.6	3.9

Section IV: A Macro Perspective on 2019 Budgets

The 1.0% annual growth in program spending that is required to eliminate the deficit in five years, rests in large part on the assumption that important efficiency gains in public service delivery will be realized year after year. This will be very difficult to achieve once the low-hanging fruits are collected in the first few years. The Fiscal Accountability Office reckons that “significant future policy decisions will likely be needed for the Province to achieve the 2019 budget’s spending projections starting in 2021-22.”[19]

We believe that the projected spending restraint, if fully realized, will entail important cuts in the quantity and/or quality of services. The fiscal drag implied by this budget will act to slow growth in Ontario somewhat, with a negative feedback on the deficit. We estimate that the negative fiscal impulses from the budget (before reserve) average 0.6% of Ontario GDP in 2019-20 and 2020-21, and 0.3% in the next three years. For this reason we proposed in our pre-budget analysis in February that the government lengthen the planned retrenchment period. The province will also need to raise more revenue from sources other than income taxes to bridge the gap between revenues and expenses.

According to the FAO, the budget’s fiscal plan incorporates provisions for unannounced measures, presumably tax cuts, which have reduced projected revenue by $2.2 billion in 2021-22, $3.4 billion in 2022-23 and $3.6 billion in 2023-24. This helps explain why revenue growth in the budget is much weaker than nominal GDP growth after 2020-21. Without these unannounced revenue measures, the government could have afforded to let its program spending grow by 2.0% per year instead of 1.2% per year over 2021-22 to 2023-24, while still balancing its budget (including reserve) by 2023-24. Somewhat higher growth in spending would materially reduce potential cuts in public services and distribute the burden of adjustment more evenly between taxpayers, service providers and beneficiaries of the services.

Ontario’s fiscal objectives are highly vulnerable to a major economic slowdown: revenues would flatten or fall, expenditures would increase more than planned and the deficit before reserve would enlarge. A slowdown to zero real GDP growth in one year would cause the deficit to increase by about $3.5 billion, far exceeding the $1 to $1.6 billion reserve provided. If this deficit were entirely financed by increased borrowing, public debt charges would increase and the province’s credit rating would be impaired. Higher debt charges would require even greater spending reductions in the future.

In short, even if the province does manage to implement its highly constrained plan for program spending over the next five years, the province is at severe risk of not being able to bring its net debt-to-GDP ratio to less than 40.0% as planned.

The 2019 B.C. Budget

The 2019 B.C. budget extends only to 2021-22, so the projections for 2022-23 and 2023-24 shown in Table 4.5 below are our own. With a small surplus and low debt ratio in 2018-19, the B.C. government eliminates the Medical Services Plan premiums in 2020 and allows program spending to grow at about the same pace as total revenues year after year, thereby keeping the budgetary balance in small surplus throughout. The government also materially increases its net capital investments relative to 2018-19, which explains why its net debt ratio rises to 16.1% in 2021-22 from 14.8% in 2018-19 even as small budget surpluses are generated throughout. Overall, the strategy laid out in the 2019 budget is much in line with the expectations we had in our pre-budget analysis.

B.C. does have some room to absorb a year of zero real growth through a mix of increased borrowing, moderate reductions in the growth of program spending and possibly of capital expenditures as well.

Table 4.5

B.C. GOVERNMENT: BUDGET 2019

					Our Own Projections	
	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Total revenues (% changes)	8.9	4.3	1.7	4.0	3.9	4.0
Program expenses (% changes)	8.3	4.4	1.8	3.5	3.7	4.0
Public debt charges ($ millions)	2,615	2,797	2,951	3,116	3,348	3,557
Budget surplus ($ millions)	374	274	287	585	630	610
Net capital investments ($ millions)	2,339	3,836	4,269	4,247	4,000	3,800
Net debt-to-GDP ratio (%)	14.8	15.0	15.6	16.1	16.5	16.7
Nominal GDP (% changes)	4.6	4.5	4.3	4.0	4.0	4.0

Alberta's Fiscal Prospects

Alberta has a low debt-to-GDP ratio because generally strong resource revenues prior to 2015 were able to pay for very high spending levels and still generate a net financial asset position. With the collapse of resource revenues after 2014, Alberta has since been a heavy net borrower, with the second highest level of per capita spending among the provinces in 2017-18, and a relatively low level of revenues relative to expenses. The trajectory of the debt-to-GDP ratio is sharply upward and unsustainable. The former Alberta government did not release an update of its Budget 2018 projections except for 2018-19 in February 2019. At that time, the deficit for 2018-19 was estimated to be $6.9 billion, even with program expenses growing at only 1.5% in the year. The new government has yet to release a budget, but given the starting point it is very hard to see how the deficit could be eliminated over the next five years without both severe spending restraint and a significant increase in non-resource revenues relative to GDP. We assume that resource revenues fall in 2019-20, but increase by over 60% in the next four years due to increases in oil production and transportation capacities. Under a status quo assumption, other own-source revenues would grow roughly at the pace of nominal GDP in Alberta (i.e., 2.0% in 2019-20 and 4.0% to 5.0% in subsequent years, and federal transfers at about 3.5% per year). Even assuming program nominal spending growth of only 1% per annum in each and every one of the next five years, the deficit would only fall to zero in 2023-24. Such a degree of spending restraint would be difficult to sustain over such a long period. It would generate a negative fiscal impulse equivalent to 0.5% of Alberta nominal GDP and 0.1% of Canadian nominal GDP, thereby slowing growth and making fiscal consolidation harder to achieve.

Section V:

Planning Parameters for Canadian Business

Our overall outlook for global economic growth has not much changed from what we presented last fall, although the downside risk of trade disruption has increased. We advise businesses to plan on the assumption that global growth in 2019 will slow to about 3.3% from the strong 3.7% experienced in 2017 and 2018. We expect that the period of slow growth that the world has generally experienced since the last quarter of 2018 is temporary. Despite trade uncertainties, we are optimistic that growth in the second half of this year and into next year will pick up, and that the world economy will operate near potential of 3.3% growth at annual rates. We think that it is appropriate to plan on moderately strong growth to continue in 2020 and 2021, on the assumption that the United States and China will come to some sort of acceptable arrangement as cooler heads prevail.

Our view is that the U.S. economy will grow at the above -potential rate of 2.5% this year, although the risk of trade disruption remains. High levels of employment and consumption will prevail as the stimulative effect of the 2017 tax cuts and expenditure increase continue, albeit at a diminishing rate. U.S. growth is likely to slow to potential of 1.9% in 2020 and 2021. Chinese growth should remain at, or above 6.0%, spurred by stimulative policy. With good global growth, the demand for commodities should grow modestly, and we look for relatively flat commodity prices over the next three years, although with fairly high month-to-month and year-to-year volatility. As we indicated last fall, we think it is appropriate to plan on WTI oil price fluctuating around a trend of US$60-$65 per barrel over the period to the end of 2021.

What has changed significantly from last fall is our view on the trajectory of interest rates. Last fall, we and most economic analysts were of the view that central banks in North America and Europe would continue to raise policy interest rates in 2019 and 2020 to more “neutral levels”. In the face of trade uncertainties, central banks in early 2019, changed their guidance about future tightening. They now say that monetary policy will be “data dependent”, which many analysts and market-watchers have interpreted as indicating reduced rates going forward. Markets have pushed bond rates below overnight rates to produce an inverted yield curve because they assign a high probability to trade disruptions actually significantly reducing growth. As we assign a very much lower probability to trade disruptions weakening growth in 2020 and 2021, we continue to anticipate central banks modestly raising policy interest rates by 2021. We thus anticipate the yield curve to revert to its normal shape by 2021.

Based on the above scenario, we think business should plan on the basis of Canadian growth averaging about 1.3% this year, up from 0.4% at annual rates in the first quarter. Growth in 2020 and 2021 is likely to come in at a little less than 2.0%. On balance, the risks to this outlook are on the downside in 2020. But, with the completion of three important pipelines, there is an upside risk that growth in Western Canada may resume more strongly by the end of 2021 as both volumes and prices of Western Canadian Select (WCS) oil improve. With the global and Canadian outlook above, the Canadian dollar should appreciate mildly to 78 U.S. cents by the end of 2021. Again, assuming the Canadian economy develops as per the above scenario, the Bank of Canada might be expected to raise its policy interest rate to 2.25% by the end of the period.

Section V: Planning Parameters for Canadian Business

In closing, we emphasize that these planning parameters are based on our analysis, which attaches a fairly low probability to a major trade dispute disrupting global growth. We think the better judgement is that calmer heads in Washington and Beijing will prevail and, that in the end, some sort of agreement will be reached that will permit business on both sides of the Pacific to invest with reasonable confidence that global supply chains still make economic sense. Similarly, we believe that CUSMA will eventually be approved by Congress, and that there are renewed opportunities for Canadian firms in U.S. markets.

Table 5.1

KEY PLANNING PARAMETERS FOR 2019-21			
	2019	**2020**	**2021**
GDP Growth %			
U.S. Real Growth	2.5 (2.5)	1.9(1.8)	1.9(1.9)
Canadian Real Growth	1.5(2.0)	1.9(1.8)	1.8(1.8)
Canadian Nominal Growth	3.4	3.8	3.7
Rates and Prices At Year End			
BoC Target (%)	1.75(2.75)	1.75(3.0)	2.25(3.0)
U.S. Fed Funds (upper %)	2.50(3.0)	2.50(3.5)	2.75(3.5)
US/C Exchange Rate	.75(.76)	.75(.77)	.78(.77)
WTI Oil Price (US$/bbl)	60(60-65)	60(60-65)	65(60-65)

Figures in brackets from *Bennett Jones Fall 2018 Outlook*.

Notes

1. See our *Bennett Jones Fall 2016 Outlook* for our analysis of "The New Normal" for growth in advanced economies.

2. In this report we use the name employed by the Canadian Government which refers to Canada first. In the United States, the acronym is "USMCA" and in Mexico it is "T-MEC (El Tratado entre México, Estados Unidos y Canadá)". In French it is "ACEUM (Accord Canada-États-Unis-Mexique)".

3. https://www.reuters.com/article/us-usa-trade-china-agriculture/us-wins-wto-ruling-on-chinese-grains-decision-also-affect-india-idUSKCN1QH224

4. WTO document WT/L/1056 refers.

5. https://www.whitehouse.gov/presidential-actions/executive-order-securing-information-communications-technology-services-supply-chain/

6. António Guterres, "Remarks to Special General Council of the World Trade Organization", Geneva, May 10, 2019.

7. G20 Leaders' Declaration: Building Consensus for Fair and Sustainable Development, December 1, 2018, Buenos Aires, Argentina, para. 27.

8. Ministers Responsible for Trade Meeting Joint Statement 2019, May 18, 2019, Vina del Mar, Chile, para. 22.

9. Roberto Azevêdo, Speech to the Peterson Institute, Washington, D.C., April 11, 2019.

10. Canada Gazette, Part 1, Volume 153, Number 4.

11. https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/may/united-states-announces-deal-canada-and

12. https://www.international.gc.ca/trade-commerce/assets/pdfs/agreements-accords/cusma-aceum/cusma-ways-means_aceum-voies-moyens.pdf

13. Excerpts from testimony by U.S. Trade Representative Robert Lighthizer before the House Ways & Means Committee on February 27, 2019.

14. See *Oilseeds: World Markets and Trade* May 2019 published by the Foreign Agricultural Service of the United States Department of Agriculture.

15. See Calgary speech by Carolyn Wilkins, Senior Deputy Governor – May 30, 2019.

16. See T.J. Carter, X.S. Chen and J. Dorich, "The Neutral Rate in Canada: 2019 Update," Bank of Canada Staff Analytical Note No. 2019-11 (April 2019).

17. It may be useful to recall that net debt is a more comprehensive measure of debt than accumulated deficit. Indeed, net debt results not only from the accumulation of budget deficits but also from the accumulation of net borrowing to finance investments in capital assets. These investments are not reflected in the measured deficits (and accumulated deficits) except through the provision for the amortization of capital in program spending. Both accumulated deficits and net debt are useful measures; provinces tend to focus on net debt in their budget documents whereas the federal government focuses on accumulated deficit.

18. David Dodge and Richard Dion, "Pre-Budget Analysis of Government Finances: 2011-12 to 2022-23", Bennett Jones, February 2019.

19. Financial Accountability Office of Ontario, *Economic and Budget Outlook*, Spring 2019, pp. 19-20.

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