Bennett Jones

Global Economic Outlook

Friday, 17 November, 2017

Presented by
David A. Dodge

ARHCA Conference

Recent Economic Developments

- The Global Economy has strengthened since last fall.
- Much of the considerable slack that existed in advanced economies in early 2016 has been absorbed.
- China continues to grow strongly.
- Emerging market economies have strengthened.
- Global Growth now at notional speed limit of 3½%.
- Canadian growth in 2017 far above potential.

Bennett Jones

Recent Global Policy Developments

- Central Banks are beginning to raise policy rates slowly but monetary conditions are set to remain accommodative over most of the next two years.
- Now expect only modest U.S. fiscal stimulation to growth, European fiscal policies less "austere" and mildly stimulative.
- Chinese fiscal and monetary policy remains expansionary.
- U.S. trade policy unsettling.

Outlook

Short-term Prospects for Output Growth (%)

	Share (%)	2017	2018	2019
Canada	1.5	3.1 (2.4)	2.1	1.6
United States	16.4	2.2 (2.3)	2.3	2.0
Euro area	12.3	2.2 (1.5)	1.9	1.6
Japan	4.6	1.5 (0.6)	1.0	0.8
Advanced economies[1]	34.8	2.1 (1.8)	2.0	1.7
China	17	6.7 (5.7)	6.5	6.3
Rest of World	48.2	3.3 (3.2)	3.6	3.6
World	100	3.5 (3.1)	3.5	3.4

1 Weighted average of Canada, United States, Euro area and Japan. Figures in brackets from Fall 2016 Outlook.

Bennett Jones

Global Issues with Implications for Canada

- Lack of progress on NAFTA negotiations.
- Uncertainty re monetary and fiscal policy.
- Chinese economic policy after the 19th Congress.

NAFTA (Status)

- Negotiations going very badly on main issues.
- American position totally unacceptable.
  - sunset after 5 years
  - no chapter 19
  - rules of origin
  - unbalanced procurement access
  - supply management
- U.S. negotiators have no desire or authority to make a deal.
- U.S. business just waking up.

NAFTA (Implications for Business)

- Do not panic; stay cool.
- Support “team Canada” offensive in U.S.
- Prepare for long period of uncertainty before some sort of arrangement will be reached.
- Prepare for U.S. withdrawal; prepare a “Plan B”.

Monetary Policy Conundrum

- Why do central banks say policy is “data dependent”?
- Unemployment is low and falling indicating strong demand and little slack in the U.S. and Canadian economy.
- But prices and wages in North America are not yet accelerating.
- Inflation is stubbornly below target.

How to Deal with Conundrum?

- Possibly conundrum will self-resolve and inflation will rise as historical models predict, but analysts are somewhat uncertain.
- Until clear evidence of rising inflation, one view is to keep policy interest rate below “neutral” level of 2½ to 3½% .
- The other view (BIS) is to raise rates quickly to neutral to reduce buildup excessive leverage and risk of financial crisis later.

Implication for Interest Rates

- Federal Reserve favours slow removal of accommodation.
- Federal Reserve likely to raise policy rate to about 2% by end 2018.
- Bank of Canada likely to raise policy rate to about 1¾% by end 2018.
- Bank of Canada and Federal Reserve policy rates “should” be nearer to 3% and long bonds 3½ to 4% at the end of 2019.

U.S. Fiscal Policy Uncertainty

- Not clear what form of U.S. tax bill will emerge and when.
- Could increase U.S. growth marginally in 2018 and 2019.
- Uncertainty may cause some changes in investment.
- No U.S. infrastructure program.

Chinese Policy after the 19th Congress

- Change in emphasis from growth at any price to transformation and "modernized economy".
- "Quality instead of Speed".
- In short run, still aim for 6½% growth with little effective change in fiscal or monetary policy.
- **Belt and Road Initiative** reinforced at the Congress.

Key Planning Parameters for 2017-2019			
	2017	**2018**	**2019**
US GDP growth (%)	2.2	2.3	2
Canadian growth (%)			
Real GDP	3.1	2.1	1.6
Household consumption	3.5	2.2	1.8
Business non-res. investment	1.9	3.8	2.9
Alberta real GDP growth (%)	4.1	2.5	1.8

Bennett Jones

Key Planning Parameters for 2017-2019			
	2017	**2018**	**2019**
Interest rates (year-end) (%)			
BOC target overnight rate	1	1.75	2.5-3.0
10-year GOC	2.1	2.75-3.0	3.25-3.75
10-year US Treasuries	2.4	3	3.50-4.0
US Fed funds rate	1.5	2-2.25	2.5-3.0
Exchange rate US$/CAN$ (year-end)	0.79	0.8	0.82
WTI oil price (US$/bbl, annual average)	51	55	60

Federal Fiscal Policy

- Federal deficit projected to continue close to $20B for next two years.
- Spending is supportive of “inclusiveness” and current employment:
  - consumption (CTB, WITB, housing);
  - indigenous issues and social infrastructure.
- But plans for investment in productivity enhancing infrastructure less clear.

Federal Infrastructure Program

- No clear federal plan for national projects.
- “Integrated Bilateral Agreements” with provincial, municipal and indigenous partners.
- Focus on “public transit” and “green infrastructure” ($30B over decade), not all “new” money.

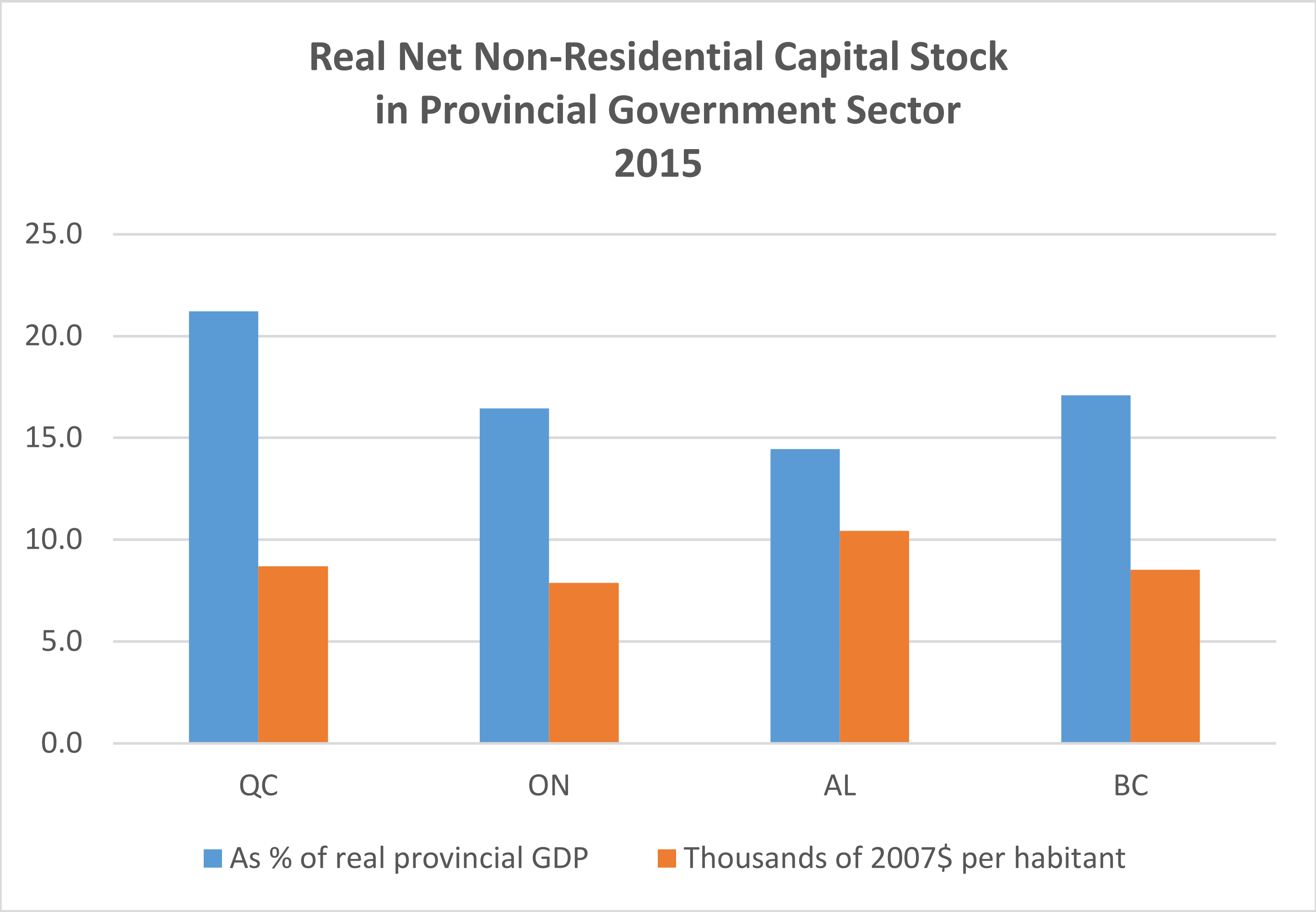
Canada Infrastructure Bank

- $35 B over 11 years allocated.
- Very slow start.
- Politicians not supportive of user pay.

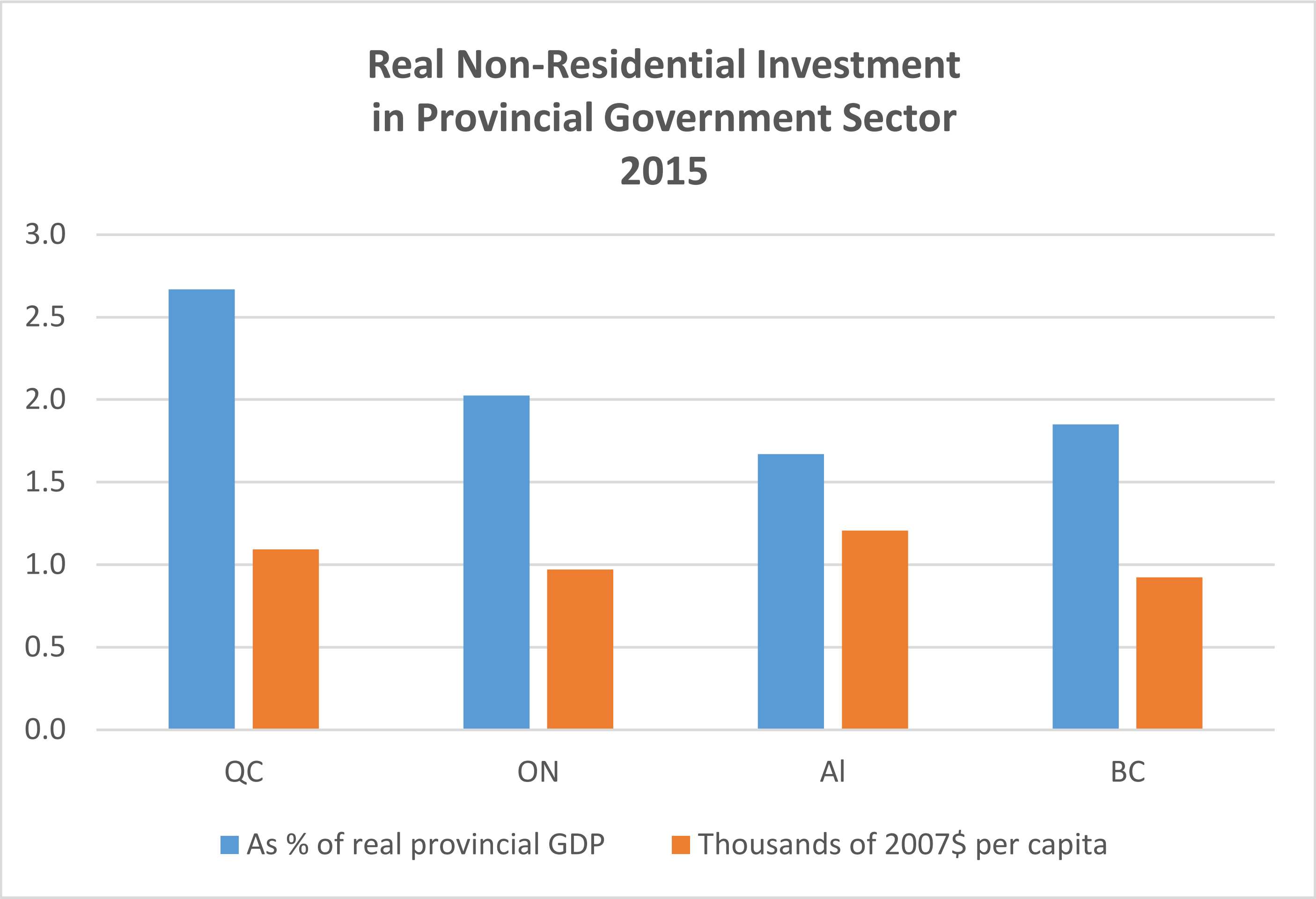
Alberta Fiscal Policy

- With low oil prices and falling income tax revenues the annual operating deficit surged to $10B plus in 2015-2016.
- Operating revenues and expenses both planned to grow by $9B between 2015 and 2019-2020.
- Total liabilities increased from $20B in 2015-2016 to projected $71B in 2019-2020.
- Much of this due to needed expansion of capital plan.

Alberta Provincial Government Infrastructure/GDP in 2015 – comparatively low

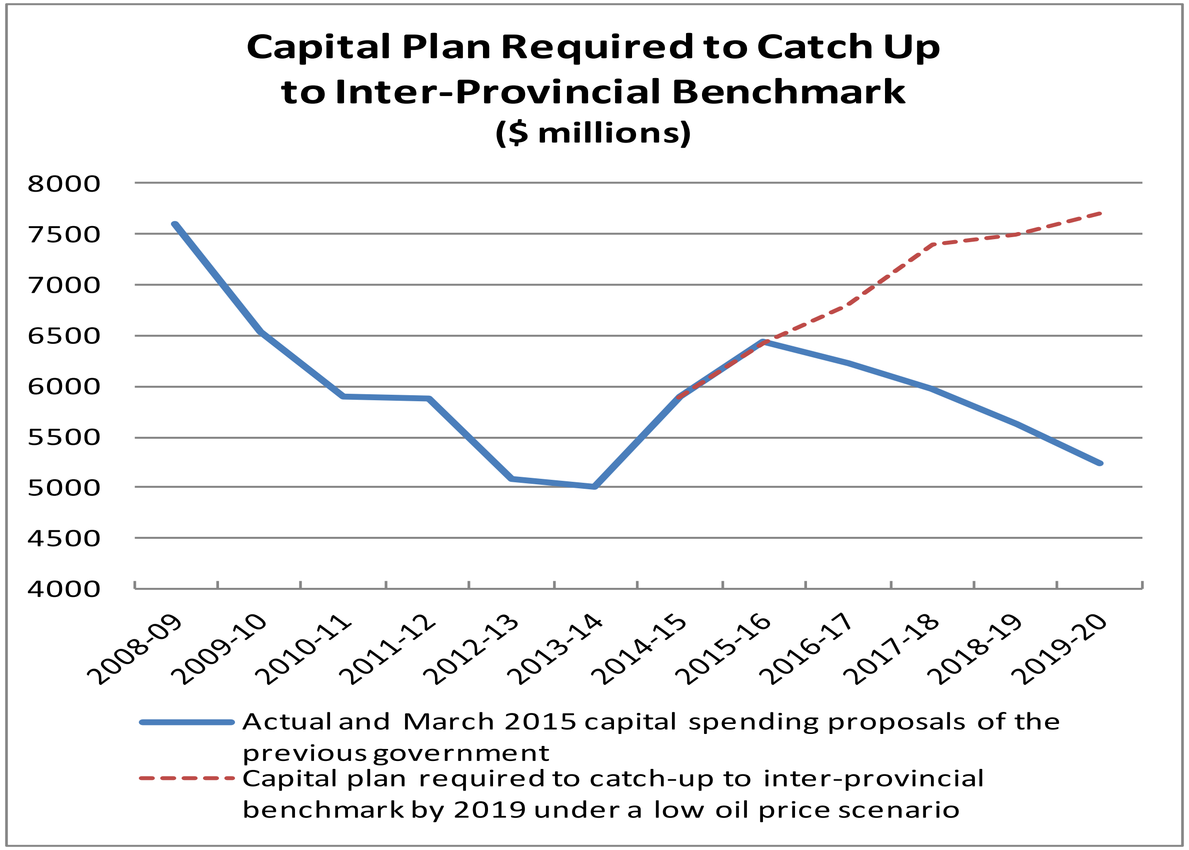


Alberta Provincial Government Real Capital Spending/GDP in 2015: Comparatively low

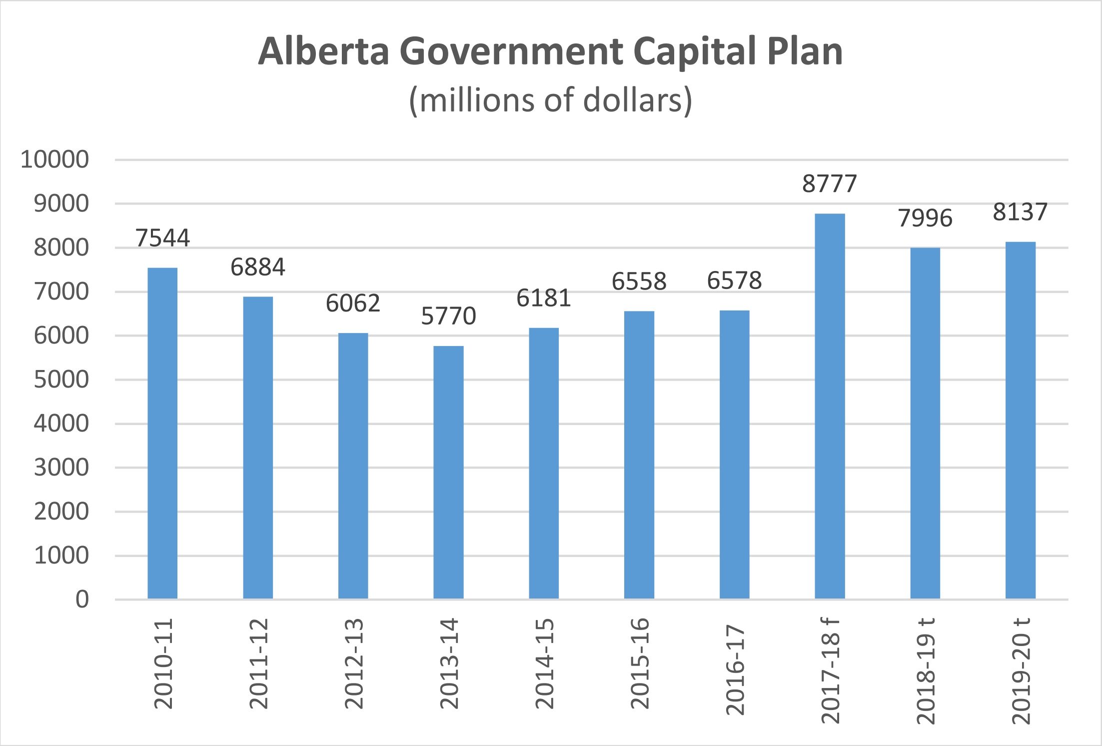


Bennett Jones

To catch-up with Inter-Provincial Benchmark:



Alberta Government Capital Plan Catching Up



Bennett Jones

Revenue-Capital Plan Mismatch

- Provincial debt increases about $30B during 2017-2018 to 2019-2020.
- Annual debt service costs rise from $1.4B this year to projected $2.3B in 2019-2020.
- Not sustainable.
- Need <u>both</u> revenue increases and spending cuts.

Revenue Increase Options

- Increase PIT and CIT: reduce the Alberta advantage.
- Increase excise taxes: unpopular.
- Introduce sales tax (HST): risk political defeat.
- Finance public use capital with user charges: best option to gauge RoR on investment but not popular.

Spending Reduction Options

- Reduce all operating spending toward per capita Ontario and B.C. levels:
  - Alberta: 12,410
  - B.C.: 9,800
  - Ontario: 9,160
  - Québec: 8,650
- Implies reduced health and education services even if wages are frozen.

Capital Spending Options

- Reduce average planned budget somewhat but smooth annual infrastructure spend.
- Introduce user charges to provide revenue offset.
- Steady long term annual spending maximizes efficiency of construction sector.

Remarks by David A. Dodge

ARHCA Conference

Friday, 17 November, 2017

Banff, Alberta

http://www.bennettjones.com/DodgeDavid/

Bennett Jones