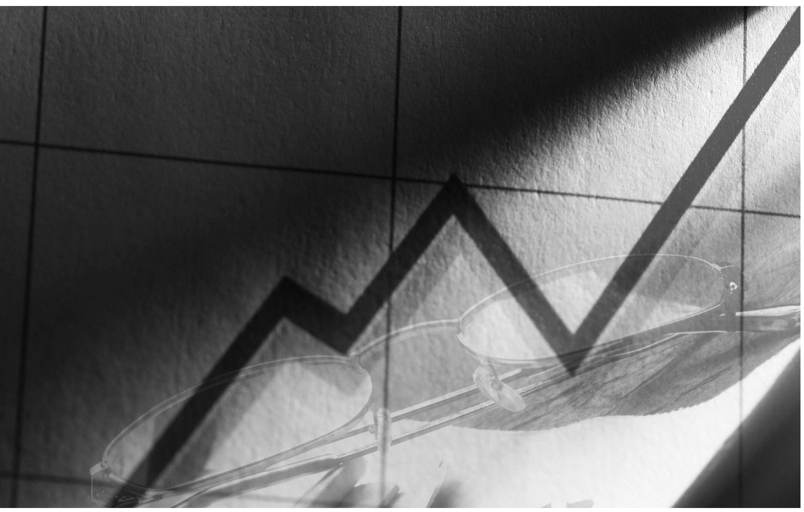
Bennett Jones Economic Outlook

Fall 2010

Recent World Economy Dynamics



The global economic recovery remained highly uneven in 2010. Growth in the emerging market economies (EMEs) of Asia and Latin America has exceeded our Spring outlook while the pace of activity in advanced economies, especially in the second half of 2010, has fallen short of what we expected in the spring.

U.S. output growth decelerated markedly to below its trend rate by the middle of the year. Over the first three quarters, housing investment continued to plummet, consumption growth was held back by very rapid household deleveraging, and net imports of goods and services widened considerably. While a definite upturn started in the Euro area in the spring, turmoil in sovereign debt markets prompted stringent fiscal retrenchment measures and a sharp widening of sovereign credit spreads that is holding back growth in many E.U. countries.

Excess capacity has remained substantial in advanced economies, holding down consumer price inflation below implicit or explicit targets. Monetary authorities in the United States, Japan, the Euro zone, and Britain have kept their policy interest rate close to zero. In addition, the Fed has just initiated a second round of quantitative easing (QE2). On the other hand, to stem risks of inflation down the road, central banks in countries that have benefitted from sound financial sectors and robust terms of trade (Canada, Australia, Sweden, Norway and New Zealand) have gradually increased their policy interest rates, although to levels that remain low.

Rapid global growth in investment in inventories and machinery and equipment supported a strong expansion of domestic demand and exports by EMEs as well as firm commodity prices. The emergence of inflationary pressures and the risk of an asset price bubble from large capital inflows and rapid credit growth prompted a general tightening of monetary and prudential policies. Some EMEs have also intervened heavily in foreign exchange markets and implemented or intensified capital controls in order to prevent an appreciation of their currency.

The Global Outlook: 2011-2012

The recovery in **advanced economies** is expected to remain timid by historical standards given the depth of the

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recent recession, although such sluggishness is consistent with previous episodes of financial crisis. Indeed, important headwinds to the recovery arise from adjustment to excessive debt associated with the crisis. This includes deleveraging by households, which will keep personal saving rates relatively high to bring debt more in line with income and assets over several years. In Canada, a high and rising ratio of household debt to household income entails the risk of an abrupt spending retrenchment in the event of an adverse shock to wealth or income.

The outlook through 2012 for house prices and residential/commercial construction is bleak as real estate markets in many countries continue to adjust to past excesses. This will further hold back private demand through adverse effects on asset values, employment and bank balance sheets. In Canada, housing investment is expected to decline in 2011.

At the same time the withdrawal of fiscal stimulus and consolidation of public finances announced by many governments will cut the contribution of public demand to growth. The fiscal stance in advanced economies will shift from a discretionary loosening in the first half of 2010 to a discretionary tightening of one percent or more of GDP in 2011. In Canada, slower government spending on goods (including fixed investment) and services will have a negative impact on growth of about one percentage point in 2011 and nearly half a point in 2012; discretionary changes in coming budgets would add to this fiscal drag.

In any event, further tightening of monetary and prudential policies combined with fiscal consolidation (already underway) and capital controls are to be expected as many EMEs struggle to contain CPI inflation and asset price bubbles.

With inventories now more in line with expected sales, inventory investment should become a neutral factor rather than a stimulant in the short term. While corporate investment in infrastructure will be moderate, investment in machinery and equipment is expected to maintain much of its recent strong momentum in many countries, including Canada. It remains to be seen when firms are going to follow up with increased hiring. Small and medium-sized firms, which account for most new jobs, indeed face credit restrictions that hamper new investment and hiring in many countries.

Emerging market economies in Asia and Latin America should continue to experience robust, if slightly slower, growth in the short term, buttressed by fast potential output growth, absence of financial excesses, relatively healthy fiscal positions, and strong final domestic demand. The better growth prospects and higher yields they offer relative to advanced countries will induce further considerable capital inflows. These inflows will add to pressures from current account surpluses for real exchange rate appreciation, either through nominal currency appreciation where exchange markets are flexible or higher price and wage inflation where they are not. In any event, further tightening of monetary and prudential policies combined with fiscal consolidation (already underway) and capital controls are to be expected as many EMEs struggle to contain CPI inflation and asset price bubbles.

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The U.S. dollar **prices of most industrial commodities**, notably metals, are expected to increase only modestly in the short term as global commodity demand growth moderates somewhat in response slowing inventory accumulation and as spare capacity in commodity production remains significant. Because of crop failures, low stocks and export restrictions, grain prices have recently surged and are expected to be high, if not to rise further, in the short term. Futures markets currently foresee oil prices remaining around their 2010 peaks and natural gas prices barely progressing from their present depressed levels. One upside risk is that a marked depreciation of the U.S. dollar and/or rise in inflation expectations in conjunction with QE2 push commodity prices significantly higher.

Monetary policy in the advanced economies is expected to remain highly accommodative in view of the rather sluggish growth in these economies, which should keep inflation low. The Fed has pledged to keep interest rates low for an "extended period" and will buy an additional $600 billion of Treasuries through June (QE2) in an attempt to lower longer-term interest rates, prevent deflation and boost asset prices. A collateral depreciation of the U.S. dollar would also stimulate activity. Barring a sharp rise in inflation expectations, interest rates, both short and long, should remain low through at least 2011 not only in the United States but across most advanced economies.

Short-Term Prospects for Output Growth (%)

	2009	2010	2011	2012
Canada	-2.5	3 (3.5)*	2.3 (3.0)	2.5
United States	-2.6	2.7 (3.0)	2.3 (3.0)	3.0
China	9.1	10.3 (8.7)	9.0 (8.0)	9.0
World	-0.6	4.7 (4.2)	3.8 (4.0)	4.0

*Figures in brackets are from the Bennett Jones Spring 2010 Economic Outlook.

Sources of Concern

The global recovery may be reasonably entrenched but the current situation is not without raising concerns for the future. First, in many advanced countries there is little financial or political room for additional fiscal stimulus in the event of a negative surprise on growth. The United States is a case in point.

Second, natural offsets to the upcoming fiscal tightening may turn out to be smaller than in the past. Not only is there little room for conventional monetary policy to provide counter-acting stimulus, given already very low policy rates, but the future effectiveness of QE2 is somewhat uncertain. In addition, the synchronization of consolidation across countries makes it more difficult for each one of them to rely on exports as offset to fiscal drag and may in fact intensify resistance to currency appreciation in order to maintain competitiveness.

Third, global imbalances will remain substantial and may well grow in the short term, increasing political tensions and the risk of new protectionist measures. Three factors are at the root of this problem: (1) several EME currencies, primarily that of China, remain undervalued relative to the U.S. dollar; (2) countries with large current account surpluses (especially Germany, Japan and China) are not generating sufficient domestic demand; and (3) there is extremely slow restructuring to encourage rotation of demand (toward exports in deficit countries and toward domestically-produced services and imported goods in surplus countries).

Fourth, the rate of growth of potential output slowed in many advanced countries in the wake of the crisis. This reduction in potential primarily reflects a fall in investment during the crisis and an increase in on-going long-term unemployment that is partly related to the necessary restructuring of major industries. This lower potential would restrain actual output growth once excess capacity is eliminated in 2013 and worsen ongoing fiscal positions of governments.

Finally, financial systems are still somewhat vulnerable to downside shocks. In Europe, markets continue to focus on the risk of sovereign debt default, unfavorable growth prospects, and the vulnerability of the banking system. In the United States, regional banks are highly exposed to weak real estate markets. Hot money flows continue to create instability in financial markets in many EMEs.

Implications for Canadian Business

The relatively anemic growth prospects for the next two years in Europe, North America and Japan imply that consumer-oriented businesses will struggle to maintain prices and margins. On the other hand, strong growth in EMEs implies strong demand for commodities and firm or rising margins for many commodity producers. With elevated unemployment persisting in North America through 2012, general labour availability should be good, although certain skills and professions will remain in high demand with rising wages and salaries. With subdued inflation over the next two years, central banks will maintain low policy interest rates in North America and Europe. Credit availability for small and mid-sized businesses is likely to improve a little more in 2011; corporations will continue to face very receptive bond markets in 2011. Generally, somewhat higher rates should be anticipated by the end of 2012. Elevated week-to-week volatility in financial and foreign exchange markets is likely to persist over the next two years, implying that businesses will need to pursue careful hedging and risk management strategies.

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In recent years productivity growth in the Canadian business sector has not only slowed but lagged far behind that in the United States. At the same time, the Canadian dollar has appreciated against the greenback. Thus, overall, Canadian business has lost competitiveness and must now innovate and invest. A strong Canadian dollar, low interest rates, and favourable credit conditions in 2011-2012 provide an opportunity to invest in machinery, equipment and technology at relatively low cost.

Needed Global Policy Adjustments

A number of policies need to be pursued to buttress confidence, promote growth and reduce volatility going into the medium term. First, countries with large fiscal deficits must launch credible medium-term fiscal consolidation plans to stabilize and then reduce their debt/GDP ratio.

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Second, a marked appreciation of the renminbi against the U.S. dollar in real terms is a key tool for rebalancing global demand. The least costly way is through China allowing a significant nominal appreciation of the renminbi against the U.S. dollar and making the renminbi convertible. A more costly and protracted way would be through higher Chinese price and cost inflation, which China has allowed to a limited degree. The most costly way of all would be through a deflation of price and costs in the United States, which U.S. policymakers will resist at all costs.

Third, structural reforms are imperative. EMEs need to reduce distorsions that lead to excessive saving rates and deter investment in the non-tradables sector. Many Asian EMEs need to increase the share of national income accruing to labour. Advanced economies need to implement structural reforms to raise potential output growth. This is urgent especially in light of the persistent negative impact of population aging. Labour market, product market and fiscal reforms are needed to encourage more labour force participation, reduce structural unemployment and stimulate productivity.

Finally, more progress in mending and reforming financial systems is important because weak banks and uncertainty over upcoming regulation hamper credit supply. This has three aspects: (1) resolving and/or restructuring weaker financial institutions through closure, recapitalization or merger; (2) clarifying and specifying regulatory reforms for banks and other large financial institutions and (3) improving the oversight of financial markets to foster increased transparency, stability and efficiency.

Implications for Canadian Governments

It is the responsibility of the federal government to continue to promote changes in international, financial and trade systems, changes that will enhance global financial stability and Canadian firms' access to global markets. Continued efforts at the IMF, BIS and WTO are essential. At home, structural and regulatory policy changes to facilitate greater competition and higher productivity growth are essential. Equally important is that both the federal and provincial governments begin to take action on credible plans to restore fiscal balance in the medium term.

Canadian governments face a period of slow revenue growth and significant fiscal retrenchment in the years ahead. General government services to the public will be reduced, some fees and taxes (e.g. Employment Insurance premiums) will be increased and considerable labour strife in the public and para-public sectors can be expected. The problems are most acute at the provincial level as these governments struggle to provide health care services to an aging population.

Were current trends to continue, total health care spending (public and private) is projected to rise from roughly 12 percent of GDP today to about 18 percent by the end of the 2020s. If governments continue to finance roughly 70 percent of health care spending, public spending on health care would rise from about 8½ percent of GDP today to 12½ percent by 2030 as a result of the expansion of the scope and quality of health care services, population aging and rising relative prices of health care services. Even if we in Canada are incredibly successful in improving the efficiency and effectiveness of health care delivery, total spending on health care will rise by 3¼ percentage points of GDP to 15¼ percent.

Absent any offloading of public expenditure onto individuals or employers, the public spending will increase by 2¼ percent of GDP even if the delivery system is brilliantly managed. Thus provinces face the unenviable choices of raising additional revenue, further slashing expenditures on other services, or offloading responsibility for financing to employers and individuals. For a complete analysis of the health care spending problem see "Chronic Health Care Spending Disease: A Macro Diagnosis and Prognosis" by David A. Dodge and Richard Dion, C.D. Howe Institute.

International Trade Issues and Negotiations

In a news release issued December 1,[1] the WTO Secretariat maintains its September projection that world merchandise trade will grow by 13.5 percent in volume terms in 2010. The rate of growth slowed in the third quarter reflecting lower economic growth. This exceptionally large increase in trade needs to be seen against the backdrop of the 12.2 percent fall in world trade in 2009. This very high growth is not expected to continue into 2011. In value terms the WTO has calculated that world trade expanded by 23 percent in the first nine months of 2010. However, the value of world trade still remains below the peak reached before the financial crisis.

In November at the G20 meeting in Seoul, leaders strongly reaffirmed their commitment to resist all forms of protectionism; they also reiterated their commitment made at the Toronto G20 to extend their standstill undertaking until the end of 2013. Despite this there are disturbing signs that protectionist pressures are on the increase fed by unsustainable global imbalances, persistent high unemployment and uneven economic recovery, particularly in developed countries. WTO Director-General Pascal Lamy has noted in his somber annual, "Overview of Developments in the Trading Environment,"[2] that new restrictive measures introduced in the period between November 2009 and mid-October 2010 cover around 1.2 percent of world imports, an increase over the level of one percent recorded in the previous 12-month period. More worryingly, he draws attention to the "danger of a steady accumulation over time of measures that restrict or distort trade and investment".

On a more positive note, both the Seoul G20 summit and the subsequent APEC leaders meeting in Yokohama offered strong support to conclude the long stalled Doha Round of trade negotiations during the course of 2011, which leaders identified as "a critical window of opportunity, albeit narrow". Any agreement will require a meeting of minds among the G5 countries, the US, the EU, China, India and Brazil. These efforts, now underway in Geneva, will test whether, in the aftermath of the midterm elections in the United States, there will be greater American willingness to engage in serious trade liberalizing efforts. The G20 commitment to "seek ratification, where necessary, in our respective systems" is relevant in this regard and is the first time the G20 has addressed the issue of the willingness of leaders to take up the challenge of fighting for the domestic ratification of a WTO deal.

In Canada, the government continues to push forward with an active program of trade negotiations. In November, Canada and India initiated free trade negotiations in pursuit of a comprehensive economic partnership agreement. Negotiators continue to register progress in the Comprehensive Economic and Trade Agreement negotiations between Canada and the EU. Canadian negotiators also continue with efforts to join the TransPacific Partnership negotiations, although Canada's high import duties in the dairy and poultry sectors, and the government's reluctance to negotiate them, have so far frustrated achieving this objective.

1. For a more detailed presentation see the WTO's December 1, 2010, press release, "Trade value growth slows in the third quarter of 2010" which can be found on the WTO website at: http://www.wto.org/english/news_e/news10_e/stts_01dec10_e.htm.
2. The full report can be found on the WTO website at: http://www.wto.org/english/news_e/news10_e/trdev_24nov10_e.htm.

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