Bennett Jones Spring 2017 Economic Outlook

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In our Fall 2016 Economic Outlook, we set out at some length our analysis of the main factors which have contributed to the low "new normal" growth rates the world has experienced since 2011. We argued that **trend** annual global growth will be restrained to 3 to 3¼. percent in the medium term and that Canadian businesses and governments should establish their medium-term plans on that basis. We recognized that, during 2017 and 2018, advanced economies could grow slightly faster than trend as slack is absorbed. But we argued that due to high uncertainty about future economic policies of the new administration in the United States and heightened political uncertainties in Europe and the UK, businesses needed to retain extra flexibility with respect to future commitments.

Our projection of sustainable trend global growth over the remainder of this decade has been revised upward from 3 to 3¼ percent last fall to 3¼ to 3½ percent today. While our view about growth in advanced economies remains much the same as before, if only slightly more optimistic, we now believe that the inevitable slowdown in China will come later than we had earlier anticipated and that growth prospects in the "rest of the world" after 2017 are somewhat better than we projected before.

Despite this upward revision, our projection for global growth to 2019 remains less optimistic than that of the International Monetary Fund (IMF) and we continue to advise business to retain extra flexibility with respect to future commitments in view of the great uncertainty that surrounds the trade, fiscal and monetary policies pursued in the United States, Europe and China. This projection remains subject to considerable risks.

In Section I of this report we review the broad cyclical, structural and policy factors that are expected to shape growth to the end of the decade, particularly in the advanced economies, and present our base outlook with a focus, as usual, on the United States and Canada. In Section II we review the issues surrounding trade policy developments in the United States and elsewhere and the implications for Canadian governments and businesses. Finally, in Section III we examine the risks to the economic outlook posed by other uncertain developments and outline the related possible impact on Canadian monetary, fiscal and structural policies.

Section I: Global Growth to 2019

In our outlook last fall we described and analyzed the negative impact that persistent weak demand and structural changes in the advanced economies have had on growth in 2011-16 and the factors that were to condition potential growth in 2017 and subsequent years.[1] As a result of weak demand since 2008, investment has been weak and skills have eroded, depressing the rate of productivity growth. In addition, aging of the population has continued to reduce the rate of growth of the labour force. With weak productivity and slowing labour force growth, potential or trend growth of GDP in the advanced economies and the world as a whole is lower today, and will be over the rest of this decade, than it was prior to 2008. We noted, however, that the considerable slack that existed in Canada and other advanced economies in the fall of 2016 would allow these economies to grow faster than potential in 2017 and 2018, and considerably faster than they actually achieved in 2016. Since October, however, uncertainty about future political developments and macroeconomic policies, notably future U.S. fiscal and trade policies, has increased. While the prospects of substantial tax cuts and deregulation have boosted American business and consumer confidence since November, until very recently hard economic data has not reflected those optimistic "animal spirits". U.S. GDP growth in the first quarter fell well below trend. In Europe, Japan and Canada, by contrast, GDP growth was much above-trend in the first quarter. In China, in the same period, real GDP growth on a year-over-year basis was slightly higher than the official 6½ percent growth target for 2017. Thus, the prospects for somewhat stronger global growth in the short term remain good, provided that the weakness in the United States in the first quarter is, as we believe, only a soft patch.

Faster demand growth is expected to raise real GDP growth rates in advanced economies in 2017-18 above 2015-16 and above trend rates. Three factors would contribute to this:

1. The adverse effects on growth of the earlier shocks that have contributed to depress demand from 2011 to 2015 are disappearing.[2] In particular, discretionary fiscal policy in the advanced economies has been shifting in 2016 from "austerity and deficit reduction" to modest expansion and will continue to do so in 2017.[3]

2. Even though central banks will increase policy rates in 2017-18, monetary policy is set to remain accommodative in advanced economies. Even in the United States, where slack has virtually disappeared, rising interest rates would still be below their "neutral"[4] level at least through 2018.

3. The projected pick-up in demand and the rise in capacity utilization in turn are set to have positive spillover effects on international trade (providing protectionist policies can be contained) and on business investment in both inventories and fixed capital, thereby providing a positive feedback effect on aggregate demand. Moreover, this increased investment is necessary to further support trend growth.

China continues to pursue a fairly aggressive fiscal policy at all levels of government. Heavy investment in domestic intercity transport and municipal infrastructure continues, as does investment in foreign infrastructure to support the policy of One Belt, One Road.[5] At the same time, Chinese authorities continue to permit rapid domestic credit expansion to sustain domestic demand in the face of a slowing rate of growth of exports. Despite the concomitant risk of future financial instability (Moody's has just downgraded China's credit rating), it appears that there is little will to reign in this rapid credit expansion, at least until after the Communist Party Congress in the fall.

Structural factors, on the other hand, should keep potential output growth in advanced economies low by historical standards and further depress trend growth in China. Potential growth matters for actual growth because it determines the speed at which an economy can actually grow without giving rise to inflationary pressures. Once an economy gets close to capacity, there is no room for its actual growth rate to exceed its potential growth rate for very long without pushing inflation up above its implicit or explicit target.

As we discussed in our Fall 2016 Outlook, low potential growth rates in advanced economies going forward arise from two factors. First, unfavourable demography, notably population aging, results in declining growth in trend total hours worked mainly by reducing the aggregate rate of labour force participation. This is a phenomenon that is

projected to be common to all the major advanced economies and to China.[6] Second, weak trend labour productivity growth rates, manifest in advanced economies since the mid-2000s, are projected to return only gradually toward their higher average rates of the previous 30 years. Productivity growth will get some support from a pick-up in business non-residential investment in response both to stronger growth in demand and to increasing pressure on industrial capacity. Nevertheless, productivity growth rates will remain fairly low in the short term by historical standards.[7] A third structural factor contributing to depress trend global growth is the transition of China toward a more sustainable growth model, implying slower growth as final demand shifts away from investment toward consumption and services and the industrial structure adjusts accordingly.

Base Case Projection

Our base case scenario calls for global growth to rise to 3.4 percent per year over 2017-19 from 3.1 percent in 2016. Our view that the advanced economies would grow at about 1.9 to 2 percent in 2017-18 is just slightly more optimistic than last fall (Table 1). We have, however, significantly revised up our projection of growth over these two years for China and the emerging economies as a group.

In the recent past, the Chinese government has shown more willingness than we had anticipated to provide fiscal stimulus and to engineer a major credit expansion in order to sustain growth at its target rate, notwithstanding that such stimulus might hamper economic rebalancing and increase already high financial vulnerabilities. To reflect this increased stimulus, we adjusted upward our projected growth rates for China in our Fall 2016 Outlook and we do so again in this Spring 2017 Outlook. In contrast to China, growth in the rest of the world is projected by the IMF to accelerate in 2017 and 2018 mainly on the assumptions that activity in Brazil and Nigeria, which experienced deep falls in output in 2016, will stabilize in 2017 and gather momentum in 2018, and that Russia will resume growth in 2017-18 with positive spillovers on other Commonwealth of Independent States countries. Growth in the rest of the world is expected to rise further in 2019. Largely as a result of upward revisions to projected growth rates in China in 2017-18 and in the rest of the world in 2018, our current projection of global growth of 3.3 percent in 2017 and 3.4 percent in 2018 is higher than in the Fall 2016 Outlook by 0.2 and 0.4 percentage points, respectively. Consequently, we also have adjusted upward slightly our projection of global growth in 2019 to 3.4 percent.

It is worth noting that our projected global growth rates fall short of those produced by the IMF in their Spring 2017 World Economic Outlook, which were 3.5, 3.6 and 3.7 percent for 2017, 2018 and 2019, respectively. We believe that the IMF continues to be over-optimistic about future global growth just as they were every year since 2012, although for advanced economies our projections are only slightly less optimistic. Moreover, the difference widens beyond 2018 as global growth stabilizes in our projection, but continues to increase in the IMF's. With respect to China, the two projections show declining growth profiles, with the IMF projected rates slightly higher on average. Together, the differences with respect to the advanced economies and China account for half of the 0.2 percentage points difference for 2017 and 2018. Differences with respect to the rest of the world account for the other half for these two years and for the full 0.3 points difference for 2019.

Table 1:

Short-term Prospects for Output Growth (%)*

	Share (%)	2016	2017	2018	2019
Canada	1.5	1.5 (1.2)	2.7 (2.0)	2.0 (2.0)	1.7
United States	16.4	1.6 (1.5)	2.2 (2.3)	2.4 (2.3)	1.9
Euro area	12.3	1.7 (1.5)	1.7 (1.5)	1.6 (1.5)	1.5
Japan	4.6	1.0 (0.6)	1.2 (0.6)	0.8 (0.5)	0.7
Advanced economies†	34.8	1.6 (1.4)	2.0 (1.8)	1.9 (1.8)	1.6
China	17	6.7 (6.6)	6.4 (5.7)	6.1 (5.2)	5.9
Rest of World	48.2	2.9 (2.9)	3.2 (3.2)	3.6 (3.2)	3.8
World	100	3.1 (3.0)	3.3 (3.1)	3.4 (3.0)	3.4

*Figures in brackets are from the Bennett Jones Fall 2016 Economic Outlook.

† Weighted average Canada, United States, Euro area and Japan

As in our Fall 2016 Outlook, our projection rests on the following key assumptions:

- No major specific shocks are assumed from political or trade developments. There is a clear downside risk to this assumption, as we outline in Section II below.
- Policy interest rates are not expected to be significantly increased by central banks in Europe and Japan over the next twelve months. As the Minutes of the Federal Reserve suggest, rates in the United States are projected to rise gradually to the end of 2018, but remain below their "neutral" level throughout the period.
- West Texas Intermediate (WTI) oil prices are assumed to trend upwards, but stay below US$60 until late in 2018. They are likely to show volatility around this trend.

United States

U.S. growth stalled in the first quarter of 2017 due to temporary factors, but should rise to above-trend growth rates of 2.2 percent in 2017 and 2.4 percent in 2018. A strong labour market, rising demographic demand for housing, strengthening energy investment and less drag from inventory investment should provide support to growth. We have assumed that Congress will approve only a small amount of fiscal stimulus, largely from tax cuts. This stimulus would raise the level of real GDP starting in 2018 by up to a cumulative 0.5 percent by 2019. With the economy at close to capacity to start with, monetary policy is expected to become less accommodative to stem the risks of inflationary pressures. By the end of 2018, we think the policy interest rate would likely have risen to 2 to 2.5 percent in nominal terms from 1 percent in the first quarter of 2017. This is still below the "neutral rate" which is currently estimated to be near 3 percent. The rising federal funds rate and a careful slow reduction of the Fed's balance sheet will likely create further upward pressure on the U.S. dollar, but still accommodate real GDP growth of about 2 percent in 2019.[8] Risks related to U.S. monetary policy will be discussed in Section III.

Canada

In Canada, real GDP growth was robust in the second half of 2016 and reached 3.7 percent in the first quarter of 2017 on the strength of final domestic demand. Household spending on consumption and housing accelerated and business non-residential investment rebounded. Since the rapidity of this advance appears to be unsustainable in light of economic fundamentals, GDP growth is expected to decelerate in the rest of the year and average 2.7 percent for 2017 as a whole. This major rebound from 1.5 percent in 2016 would essentially eliminate slack in the economy,[9] given that potential growth is estimated to be around 1.5 percent.

Consumption and housing demand in 2017 should remain strong, but particularly important will be a pick-up in investment in inventories and business fixed investment, both of which were very weak in 2016. In 2018, real GDP growth is projected to slow to 2 percent mostly because of a slowdown in housing, government spending, and investment in inventories. In 2019, with the economy operating at close to capacity, we project growth at 1.7 percent, not much above our estimate of potential growth.

The 2017 federal and provincial fiscal plans provide for a small increase in budgetary deficits in fiscal year 2017-18 followed by slightly reduced deficits in subsequent fiscal years (Table 2). The direct budgetary impact on growth will be slightly expansionary in 2017-18 and very mildly contractionary in 2018-19 and 2019-20. However, in addition, some governments (Ontario and Alberta in particular) plan to borrow considerable additional amounts on capital account to fund off-budget investments in physical infrastructure. Taking lags into account, "net borrowing" will thus be appropriately expansionary in 2017-18 and probably still slightly expansionary in 2018-19, even as the economy nears capacity. Current plans call for mildly contractionary policy the following year.

Table 2:

Budget deficits - $billions

	2016-17	2017-18	2018-19	2019-20
Federal	23	28.5	27.4	23.4
Ontario	1.5	0	0	0
Quebec	-2.3	-2.5	-2.8	-3.2
Alberta	10.8	10.3	9.7	7.2
B.C.	-1.5	-0.3	-0.2	-0.2
Total	31.6	36.0	34.0	27.2
Changes as % of GDP		0.2	-0.1	-0.3

Should the Canadian expansion continue in 2017 as we project and the Bank of Canada expects, the Bank of Canada would likely hold its policy rate stable until close to the end of 2017 before initiating gradual rate increases. This implies that the gap between the policy rate in the United States and Canada will likely widen by at least 0.5 percentage points in 2017 and early 2018 before the pace of increases by the Bank of Canada more nearly matches that of the Federal Reserve.

The implication of this outlook for relative monetary policies in Canada and the United States, combined with the assumption that the trend WTI oil price will not rise above US$60 in 2017 and 2018, implies that the Canada-U.S. exchange rate will likely continue to trade in the current 72 to 76 cent range in the short run while the NAFTA is under negotiation. Assuming no large negative shock for Canada from the outcome of these negotiations, the Canada-U.S. exchange rate should return to the 76 to 80 cent range consistent with our North American growth and monetary policy projections. Businesses should use this higher range for planning purposes.

In Section II, we examine the possible outcomes of those negotiations and other possible trade shocks. In Section III, we return to an analysis of all other risks to the global and Canadian economic outlook and the implications both for fiscal and monetary policies and for business investment strategies.

Section II: Trade Policy Developments and Risks

This section focuses on the factors that will influence the development of U.S. trade policy under the Administration of Donald Trump. We look in particular at the impending renegotiation of the NAFTA and U.S. policy towards Canada and Mexico, but it is important to consider as well the effects of President Trump's trade policy on the global trading system. In addition, we also look at other significant developments such as Brexit and efforts by Japan to revive the Trans-Pacific Partnership (TPP) without the United States. Finally, we make some recommendations for Canadian policy makers in this challenging environment.

In our Fall 2016 Outlook we flagged the uncertainties created by the bombastic statements made by Donald Trump as a candidate and in the first couple of weeks of the transition. We suggested then that the transition would be more complicated than most, and it might be at least summer before some important points were clarified. The process of making key appointments and determining priorities is going slowly. But in the first four months of the Administration we have seen some decisions and some adjustments as the president and his core team make a difficult transition from campaigning to governing.

Trump's Trade Policy and the NAFTA

The President set the tone in his inaugural address, *"From this day forward, it's going to be only America first, America first. Every decision on trade, on taxes, on immigration, on foreign affairs will be made to benefit American workers and American families."* Three days later, on Monday, January 23, he signed the order withdrawing from the Trans-Pacific Partnership Agreement. But then the pace of actual decisions on trade slowed down. In part, this has been a learning process for the Administration. It appears that the constitutional role of Congress on trade and the need for the Administration to operate within the constraints of the Trade Promotion Authority (TPA) law passed in 2015 was not fully appreciated by the new team. Developing a position on NAFTA renegotiation has frustrated the president who lashed out at the TPA calling the process "horrendous" and "ridiculous". The Administration is also learning that the business community, most members of Congress and many state governments see the NAFTA as very important for the United States They also value their trade relationships with Canada and Mexico. For the first 100 days, the signals on the direction of American trade policy have been confused.

This may now be changing with the swearing in on May 15 of Robert Lighthizer as the U.S. Trade Representative (USTR). In his legal career, Lighthizer represented mainly American steel industry clients on anti-dumping and countervailing duty complaints and seems comfortable operating within the broad lines of Trump's "America first" approach to trade. He is an opponent of what he considers to be a too-activist approach by the WTO's Appellate Body and he is an opponent of the special binational panels Chapter 19 of the NAFTA. From a Canadian perspective, he is certainly not an ideal candidate for this post. However, he has previously served as Deputy USTR during the Reagan Administration. He understands how the trading system works both internationally and inside the United States. In his first days in office, he has shown a deft leadership approach on the NAFTA and at the Asia-Pacific Economic Cooperation trade ministers meeting. Expect him to be a formidable adversary at the negotiating table, but one who understands that the NAFTA is important to many U.S. interests. He has emerged quickly as the principal spokesperson of the Administration on matters of trade negotiations.

On May 18, Lighthizer sent the notice to Congress of the president's intention to initiate negotiations with Canada and Mexico to modernize the NAFTA. The notice is brief—less than a page and a half—but clearly recognizes the need to work closely with Congress and to consult the trade advisory committees to obtain business views. The letter states that the aim of the Administration is modernization of the NAFTA. It does not mention the word "renegotiation". Unlike an earlier leaked draft of the notice, the actual notice does not get into a detailed description of objectives, but instead wisely says the objectives will be those contained in section 102 of the *Trade Priorities and Accountability Act* (*i.e.*, the TPA law passed in 2015). It is worth noting that the objectives in section 102 cover 13 pages of single-spaced statute.

To see the real priorities of the Administration, we will need to wait until the actual negotiations begin, probably in late August or September. The notice commits the Administration to "consult closely with Congress in developing our

negotiating positions". It also states that the Administration "will continue to review elements of NAFTA and, where appropriate, update U.S. approaches". The letter also says that "we intend to initiate negotiations with Canada and Mexico as soon as practicable, but no earlier than 90 days from the date of this notice". In other words, it may take longer than 90 days for the U.S. team to be ready to start negotiations.

Clearly, major consultations lie ahead to broker the detailed U.S. approach among competing American interests. This will involve consultations with Congress, the trade advisory committees and various other American interests. It will also involve considerable debate within the Administration and even inside the White House. Expect Lighthizer as USTR, probably working closely with Commerce Secretary Wilbur Ross, to lead this process of determining the American position for the NAFTA negotiations.

Getting Lighthizer in place was a critical step but it should be noted that the Administration still needs to ensure the appointment (and Senate confirmation) of other senior personnel in the Office of the USTR, the Commerce Department, and other agencies. To function effectively the Administration needs input from key interagency committees staffed by senior officials at the deputy level. These committees formulate advice for Cabinet officers. At the moment, the United States simply does not have sufficient competent personnel trusted by the Administration to go up against top Canadian and Mexican negotiators.

Content of the NAFTA Negotiations

When real negotiations get underway, expect four categories of issues to be on the table:

1. Modernization proposals (perhaps borrowed from TPP and Canada-European Union Comprehensive Economic and Trade Agreement [CETA]) to update the NAFTA to take account of what has changed in the world over the last 25 years, including:

    a. A chapter on digital commerce.

    b. Updating provisions on customs administration to take account of the fact that these activities are now digitized.

    c. Conducting a review of certain NAFTA chapters in need of updating. For instance, a review of the rules of origin for automobiles would identify that cars are no longer made from the same components as 25 years ago and that updating is clearly desirable.

2. Proposals for strengthening trilateral cooperation to ensure the competitiveness of the North American marketplace in a challenging global environment, including:

    a. Building on the Mexican reforms in energy to complete and update the NAFTA provisions on energy. The Canadian oil and gas industry and related service providers are already following up on the opportunities created by these reforms. The NAFTA negotiation can be used to build these reforms into a NAFTA which will offer greater security to investors in the sector. It also offers the opportunity to make additional improvements, such as restricting the circumstances in which proposals for cross-border energy projects could be turned down. Of course, the American oil and gas industry will have very similar objectives.

    b. Building on the Mexican reforms in telecommunications to fill the void left by the failure to negotiate a NAFTA chapter on basic telecommunications. An objective of such a chapter should be to reduce the cost of telecommunications services to North American businesses and consumers and ensure that such services are at least as competitively priced as those in other major global markets.

    c. Developing improved approaches to cooperation in customs enforcement.

    d. Considering possible new cooperation among the three North American countries in addressing injury caused to North American value chains by dumped or subsidized imports from offshore countries. This could be a modernization of Chapter 19 of the NAFTA.

3. Addressing the concerns of President Trump and others in the Administration about the impact they allege the NAFTA has had on the American manufacturing sector and particularly their perception that the NAFTA has been a major cause of job losses. These concerns could lead to negotiations on:

   a. Tightening the rules of origin to make it more difficult to use offshore components in the production of automobiles in North America.

   b. Strengthening American capacity to restrict softwood lumber imports by, for instance, eliminating the special binational panel process in the NAFTA Chapter 19.

   c. Strengthening American capacity to promote the use of American goods and services in government procurement and in major public projects.

   d. Opening up the Canadian market for American dairy products.

   e. Seeking provision for further renegotiation of the NAFTA in the future if the United States is running a significant trade deficit.

4. Proposals from Canada (and Mexico) to address longstanding concerns in the United States by proposing to:

   a. Reduce the reach of 'Buy America' by upgrading the NAFTA provisions dealing with the government procurement and prohibiting the use of "localization requirements" in major public projects.

   b. Update and improve provisions dealing with temporary entry of business persons.

   c. Ensure that American dairy programs operate in a way that respects WTO rules and consider how the American market for dairy products could be opened up to provide reciprocal access for Canadian dairy products.

   d. Amend the *Jones Act* to eliminate its restrictive cabotage requirements on trade among the NAFTA countries.

   e. We should also bear in mind the impact of possible provincial actions, such as B.C. Premier Clark's proposal to tax thermal coal exports going through the port of Vancouver and her request to Prime Minister Trudeau for support. Both Albertan and American coal exports could be affected. Such developments are not part of the NAFTA negotiations but could have a spillover effect.

   f. The first two categories should involve constructive engagement by the 3 partners. The latter two will be more contentious.

We support the approach taken by Minister Freeland that the Canadian government should see this negotiation as a unique opportunity to update and modernize the NAFTA. Going further, we suggest the North American countries use the occasion to improve the competitiveness of the North American marketplace, notably by liberalizing trade in highly protected sectors, thereby eliminating the economic rents accruing to a few companies and producers.

Timing

The likely time frame for the negotiations raises a number of considerations. An early and successful conclusion would help restore business confidence. On the other hand, the passage of time may also result in the American negotiating position being shaped more by forces in the United States that understand the value of the NAFTA and support it.

Both Mexico and Canada are actively preparing for the NAFTA negotiations. Although the United States is the original proponent of a renegotiation and repeatedly stressed its urgency, it is taking some time to put their negotiating position together for reasons described above.

Looking at the road ahead, a number of serious political hurdles for the negotiators can be seen. Next year is an election year in both Mexico and the United States The Mexican presidential elections are in July and U.S. Congressional elections are in November. Most observers think it unlikely such a major negotiation could be concluded during these

election periods. There is a narrow window of, say, three or four months in 2017 for trying to complete negotiations. But it seems improbable that such a complex and potentially controversial negotiations could be completed in such a short period, particularly when there does not seem to be a meeting of minds at the highest levels of the three governments on the objectives of the negotiations. Despite all this, it will be beneficial to business confidence to get the process launched as soon as possible. Realistically, however, we must be prepared for the possibility that these negotiations will not come to a head until 2019, a Canadian election year.

Other International Trade Developments

The direction of U.S. trade policy on a global basis will also have potentially significant economic effects. The contents of the May 27 G7 Leaders' communiqué from Taormina are cause for concern. Last year the G7 committed to "fight all forms of protectionism". This year the equivalent reference reads "… we reiterate our commitment to keep our markets open and to fight protectionism, while standing firm against all unfair trade practices." The notion of unfair trade practices is new in the communique and clearly offers the U.S. scope to take action against practices that they consider to be unfair. The communiqué then goes on to commit leaders to "push for the removal of all trade-distorting practices—including dumping, discriminatory non-tariff barriers, forced technology transfers, subsidies and other support by governments and related institutions that distort markets—so as to foster a truly level playing field." Such an approach and such a listing appears for the first time in a G7 communiqué—clearly another victory for the United States. This will complicate the Canadian government's efforts to argue that assistance to Bombardier is legitimate. It will also be important to monitor the U.S. approach to the WTO Ministerial meeting in December in Buenos Aires. Beware of likely U.S. efforts to reform the WTO dispute settlement system, which would have significant negative consequences for Canada given that this is where most Canada-U.S. trade disputes are litigated. The fact that other G7 leaders have acquiesced to Trump's approach sends a negative signal to the world and to global investors.

Efforts to revive the TPP without the United States should be followed closely. The recent meeting of the 11 TPP signatories, other than the U.S., show that there is interest in considering this possibility but that there are different views on how this might be done. For Canada, we would argue that this is an important way to further Canada's Asian agenda, including the prospects for establishing a free trade relationship with Japan. We would also argue that only minimal changes should be made to the existing text of the TPP to make it more likely that the United States could be encouraged to join in the next few years.

We also urge the government to push forward with exploring the negotiation of a high quality Free Trade Agreement (FTA) with China. Developing and putting in place an improved trade framework with China should be an important part of Canada's efforts to diversify its trading relationships.

We would also urge Canada to accelerate its negotiations with India and to initiate negotiation of a FTA with the Association of South East Asian Nations.

Finally, a top government priority should be bringing the CETA with the EU into force at the earliest possible date this year; hopefully by July 1. Canada should also monitor the Brexit negotiations and initiate early discussions with the UK to determine the best way of preserving the benefits of the CETA as between the UK and Canada after the UK leaves the EU. After all, Canada does more trade with the UK than it does with any other EU member state. It is not yet clear whether the Brexit negotiations will be successfully managed to avoid serious trade disruption, which would not only be damaging in Europe, but also to other countries like Canada that trade in the region.

Conclusion

The trade policies of President Trump pose obvious risks to global trade and trade agreements, and to Canada in particular. However, we believe that there are also important opportunities emerging from this situation. In particular, we now have a real shot at modernizing the NAFTA, which could make the agreement more resilient and more conducive to strengthening the competitiveness of North America in the broader global trading environment.

Uncertainty about the course of U.S. trade policy has also meant that other countries are rethinking their approach and looking to develop opportunities with other partners. Canada should vigorously pursue such opportunities as a part of its global approach to developing new trading opportunities.

From the perspective of the business community, it is good news that we are seeing some moderation of the extreme views on trade put forward on the campaign trail. Immediate threats of restrictive trade actions have receded somewhat. However, there is still considerable uncertainty about what trade actions the Trump administration might take and what might happen in the NAFTA negotiations. For planning purposes, businesses will need to follow developments closely and recognize that this uncertainty may persist until the NAFTA renegotiations are completed, which could be as late as 2019.

Section III: Risks to the Projection

U.S. Risks

The United States is currently a major source of risks to the economic performance of Canada and the rest of the world because of the unusually large uncertainty surrounding future U.S. economic policies. The previous section presents the probable trade policy developments in the United States in the short term and their implications for Canadian governments. It suggests that while the NAFTA is being renegotiated over the next two years or so the prospects for the imposition of U.S. protectionist trade measures against Canada are low. If there is an impediment to Canadian growth over this period, it will not come from a restriction of exports to the United States but rather from Canadian businesses holding back investment pending a clearer view of the outcome of the NAFTA negotiations and other U.S. policy initiatives. How important this will be is hard to ascertain at this stage. As Governor Poloz reported, "The Bank's most recent survey of Canadian companies showed that many see negative risks from potential policies. These risks include increased protectionism, reduced competitiveness of Canadian firms if U.S. corporate tax rates are lowered and possible delays in implementing pro-growth U.S. policies."[10]

Canadian business faces some additional sources of uncertainty. Regarding monetary policy, questions arise about (1) the size and timing of the upcoming increases in the Fed funds rate, and (2) the size and timing of the reversal of the quantitative easing that has taken place since 2007. This second factor would have the effect of directly raising long-term interest rates over and above the levels that would reflect any rise in expected future short-term interest rates. Major surprises on U.S. growth or inflation, or unexpectedly large movements of the U.S. dollar exchange rate, could prompt the Federal Reserve to tighten its policy at a time and at a pace that may significantly differ from our expectations set out in Section I (Fed funds rate up to 2 to 2.5 percent by the end of 2018 and slow and deliberate reduction of the Federal Reserve's balance sheet). However, we judge the risk of major surprises to be relatively low. Thus, we think businesses can plan with reasonable confidence that short-term interest rates in Canada and the United States will increase by close to one and a half percentage points over the next two years and that longer term rates should increase by slightly larger amounts.

The new U.S. Administration is set to alleviate the "burden" of financial regulation on financial institutions, including modifications of some provisions of the Dodd-Frank legislation, and to weaken consumer protection.[11] If passed, revised legislation would mean somewhat easier access to credit for higher-risk borrowers in the United States and somewhat less contractionary impact from expected increases in policy interest rates. While the implications of these regulatory changes could be significant for Canadian financial institutions operating in the United States, the implications for Canadian non-financial business would likely be relatively small.[12]

The Trump Administration in April and May set forth plans for sizeable cuts in taxes and expenditures that it claimed would eliminate the budget deficit in a decade by assuming GDP growth accelerating to 3 percent by 2021. Detailed proposals for the 2018 fiscal year and beyond are yet to be worked out. Thus, estimation of the resulting net borrowing and its impact on growth in the short term is almost impossible to do with any degree of confidence. It would also be premature because the current proposals will undoubtedly be substantially modified by Congress if for no other reasons than the spending cuts would hit low-income groups and many government functions incredibly hard. Moreover, there is not much room for tax cuts under plausible assumptions for future U.S. growth. It thus seems that there are risks on both sides regarding the cumulative 0.5 percent stimulus to U.S. real GDP by 2019 assumed in our projection. What is very clear, however, is that President Trump's dream of sustained 3 to 4 percent real GDP growth is total fantasy.

Some cuts in corporate tax rates are likely to come through, eventually. The extent to which this will be accompanied by a broadening of the tax base remains to be seen. A decline in U.S. corporate tax rates per se would enhance U.S. competitiveness and make investment in Canada by U.S. firms less attractive. But major reductions in the U.S. corporate income tax burden could only be contemplated if there were to be a significant new source of revenue as envisaged

in the House GOP proposal for a "destination-based cash flow tax".[13] At the moment, it appears that such a proposal has a low probability of being passed by Congress. But if it were to pass, Canadian firms exporting to the United States would be seriously affected and Canada-U.S. supply chains badly disrupted. While there would be some offsetting upward pressure on the U.S. dollar, the decline in the value of the Canadian dollar would not be enough to offset the loss of competitiveness due to the imposition of border adjustments in the U.S. corporate tax system. This border-adjusted cash flow proposal constitutes as big or bigger risk for a broad spectrum of Canadian business than do changes to the NAFTA.

A reduction in the U.S. personal income tax (PIT) rates would make Canada a less attractive place to work for highly skilled professionals and entrepreneurs who are essential to generate innovation and growth. The likelihood of a significant reduction in statutory rates of federal personal income tax, however, appears to be low because the revenue loss involved would be so large.

In summary, we think that the risk to Canadian exporters from a U.S. economy growing substantially slower than we project is fairly small and balanced by a fairly small commensurate upside risk to U.S. growth. However, in addition to the trade risk discussed in Section II, the biggest U.S. policy risk stems from the adoption of a border adjustment proposal for U.S. corporate income tax. At the moment the chances of this passing look fairly low, but if it does, the impact in Canada will be large. The risks to Canadian business stemming from amendments to financial regulation, changes in the Federal Reserve monetary policy and changes in the personal income tax system add to business uncertainty. However, we believe that the changes most likely to take place could be managed relatively easily by most Canadian businesses.

Other Global Risks

Both the euro area and Japan experienced more robust growth than expected in the first quarter of 2017. For Japan, the 2.2 percent growth in the quarter culminates the longest run of sustained GDP growth in more than a decade. For the euro area, it was the second quarter in a row of 2 percent growth. In both cases it seems that the economy more fully responded to very accommodative financial conditions and strengthening global growth. These developments suggest that there is more an upside than a downside risk to our projected growth rates of 1.2 percent for Japan and 1.7 percent for the euro area in 2017, and by implication, probably a small upside risk to global growth from these sources this year.

In contrast, we believe that there is more of a downside than an upside risk to our growth projection for China, but only beyond 2017. The more the Chinese authorities use credit expansion to stimulate public and private investment in order to prop up growth, the more they exacerbate financial vulnerabilities and increase central government's contingent liabilities. Sooner or later the government will have to restrain credit. Meanwhile, potential output growth is declining as population aging slows labour force growth and the economic transition towards services entails important adjustment costs and a fall in trend productivity growth.

Perhaps more important than specific country risks is the general downside risk related to uncertainty about the efficacy of the WTO and the IMF in steering the world economy toward policies favourable to global growth. President Trump has clearly indicated that the United States will not provide positive leadership.

Domestic Risks

Our Canadian projection is exposed not only to the above outside risks but also to risks originating in Canada. One such risk relates to the financial vulnerability of the household sector and mortgage lenders caused by the high and rising level of mortgage indebtedness relative to income and the increasing share of borrowers with high mortgage debt. Moreover, in some markets self-reinforcing price expectations are pushing up housing prices, leading to potentially unsustainable price levels. As the Bank of Canada has stressed, this vulnerability could result in a larger retrenchment in household spending than otherwise in the event of a recession. However, the risk of a recession in Canada, which could cause employment to fall and precipitate a sharp correction of housing prices, appears relatively low in the short

term as discussed above. Moreover, the new housing finance rules put in place by the federal government in the fall of 2016 is moderating somewhat the rise in highly indebted households while measures introduced by the Government of Ontario last April may abate short-term speculative demand and prevent reselling properties pre-construction. However, the longer term impact of rent control measures on the supply of rental accommodation is clearly negative.

High household indebtedness amplifies the risk of consumer spending retrenchment in the event of a considerable rise in mortgage interest rates. Mortgage interest rates move roughly in concert with bond yields, which we project (Section I) to rise only gradually through 2019. Homeowners who renew their mortgages at the higher rates may be forced to increase their saving rate, perhaps substantially, to meet their larger mortgage debt charges. The aggregate impact of the rise in mortgage rates would depend on a number of factors, including the response of monetary policy to slower growth than otherwise. Overall, we judge the downside risk to Canadian growth related to household financial vulnerability to be fairly small in the short term, but potentially considerably more significant over the remainder of the decade. We do not think that there is an imminent risk of a Canadian housing sector meltdown similar to that which occurred in the U.S. in 2007-08. However, the risk of a serious price correction will increase if house prices rise much further especially in the GTA and lower mainland.

Like the Federal Reserve, the Bank of Canada may delay or accelerate the pace of our projected increases in policy interest rate in the event of major surprises on Canadian growth or inflation or unwarranted movements in the Canadian dollar exchange rate. At this stage our projection is consistent with the view that the Canada-U.S. short-term interest rate differential will widen in favour of the United States over the next six to twelve months, but then will remain unchanged for a while before starting to narrow possibly sometime in 2019. This profile would tend to put downward pressure on the Canadian dollar exchange rate until at least the end of this year. Incoming information about U.S. policy prospects, including the NAFTA, may well generate appreciable variations in the Canadian dollar in the short term and at times keep it in the lower portion of the 71 to 77 U.S. cents range that we foresaw in the Fall 2016 Outlook. For investment planning purposes, however, it may be wiser to focus on what the exchange rate is likely to be by the end of the decade. In this regard, a range of 76 to 80 U.S. cents appears consistent with an oil price of around US$60 per barrel and stable or slightly falling interest rate differentials between the United States and Canada.

Notes

1. See "Section 1: The New Normal–Low Growth: 2011-2016", in *Bennett Jones Fall 2016 Economic Outlook*, November 2016.
2. This would include inter alia the 2008–09 global financial crisis, the 2011–13 euro area crisis, and the commodity price falls of 2014-15. Several advanced countries benefitted from the latter but others, like Canada and the U.S., experienced a collapse of investment in their oil and gas sector.
3. This is based on IMF, *Fiscal Monitor*, April 2017, table 1.1.b. See below for an overview of fiscal plans in Canada.
4. The neutral interest rate is a theoretical concept that refers to the policy rate consistent with the economy operating at capacity and inflation remaining on target. Prior to 2008, this was thought to be about 4 percent in the U.S. Most analysts think that today the neutral rate is only 2¾ to 3 percent as potential growth is lower and saving and investment patterns have changed.
5. "One Belt, One Road" is a development strategy proposed by China that focuses on connectivity and cooperation between Eurasian countries, primarily China, the land-based Silk Road Belt and the oceangoing Maritime Silk Road.
6. See "Section II: Factors Conditioning Growth: 2016-2020+", *Bennett Jones Fall 2016 Economic Outlook*, November 2016.
7. For a discussion of productivity growth, see "Section II: Factors Conditioning Growth: 2016-2020+", *Bennett Jones Fall 2016 Economic Outlook*, November 2016.
8. U.S. potential growth at that time is expected to be about 1.9 percent.
9. In its May 24 press release, the Bank of Canada notes that "The Canadian economy's adjustment to lower oil prices is largely completed and recent economic data have been encouraging, including indicators of business investment."
10. S. Poloz, "Canada and Mexico: Common Issues in Uncommon Times", Bank of Canada, 4 May 2017.
11. Proposed changes with respect to the protection of consumers are particularly contentious.
12. Financial regulation changes in the U.S. are unlikely to lead to a reduction in capital standards by the Office of the Superintendent of Financial Institutions (OSFI). However, the consequent changes in global regulatory processes at the Basel Committee and Financial Stability Board may afford OSFI more leeway in its supervisory approach.
13. This is also called "border adjustment tax".

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