Bennett Jones Economic Outlook

The year 2011 has been rich in shocks that reverberated through the global economy. They have heightened uncertainty and dampened both the already timid recovery in advanced economies and the robust expansion in emerging markets that we had expected for 2011 and 2012. Still, the same pattern of a two-speed world continues, with deleveraging constraining growth in mature economies, and investment and consumption supporting solid growth in the EMEs.

In the first section of this fall edition of the Bennett Jones Economic Outlook, we describe the world economy dynamics at play and provide a baseline short-term economic outlook for the world and Canada, as well as an alternative scenario of recession in advanced economies as a result of inadequate policies. Some implications for Canadian business are drawn. In the second section, we discuss factors affecting the evolution of trade and trade policy. In the third section, we look at the implications of a two-speed Canadian economy for provincial fiscal situations and federal transfer programs.

Recent Dynamics and Short-Term Outlook for the World Economy

Recent World Economy Dynamics

Our fall 2010 Economic Outlook foresaw that global growth was to slow markedly from about five percent in 2010 to more sustainable rates in the range of four percent per annum in 2011 and 2012. In fact, the global economic recovery has slowed more than expected in 2011, with growth in advanced economies substantially contracting, and the robust expansion in emerging market economies (EMEs) losing some momentum. Four sets of forces are currently at play. First, there is a long-run process of economic *convergence of EME's with advanced economies*. This implies two-speed world growth that has been observed in the last decade, and is expected to continue for quite some time.

Second, there is the *legacy of the financial crisis* in the form of balance-sheet restructuring, credit constraints and protracted housing price weakness. On the basis of past experience, this adjustment to excessive debt should continue to dampen the recovery in advanced economies for several years.

Third, there is the *effect of economic policies*. In EMEs, where inflationary pressures have intensified this year, authorities have deployed efforts to tighten monetary policy and curtail credit expansion. This is expected, along with weaker demand growth in advanced economies, to continue to moderate the momentum of EMEs in the short term. In advanced economies, monetary policy is exceptionally accommodative (and is committed to remain so in the short term), but there is much uncertainty about whether this is enough to support a solid recovery in a context of private sector deleveraging, fiscal austerity and fragile confidence. Fiscal policies have tightened markedly in 2011, particularly in Europe, and this has taken its toll on growth. Further significant consolidation is expected in 2012. In the United States, as the Congressional Joint Select Committee on deficit reduction has failed to reach an agreement on additional budgetary savings over ten years, automatic procedures for reducing spending could result in excessive fiscal austerity in 2013. This would significantly increase the chances of a recession.

Finally, there is the *effect of a spate of "events"* that have hampered global growth this year through their impact on supply chains, oil price, financial markets, and confidence: tsunami in Japan and floods in Thailand, political upheaval in the Arabic world, sovereign debt problems in Europe's periphery spreading to Italy and Spain, and the breakdown of political capacity in Washington to deal with US fiscal issues. These last two factors, especially the apparent ineptitude of European political leaders to deal effectively with a worsening sovereign debt crisis, currently contribute to exceptionally high fiscal and financial uncertainty, and indeed represent major risks to short-term growth prospects.

Short-Term Outlook: 2011-2013

The current high level of uncertainty puts any projection at great risk. Therefore, this section presents not only a baseline scenario, but also an alternative one of recession in advanced economies as a result of inappropriate policies. This particular choice does not mean that we rule out the possibility of positive surprises in the short term, only that risks on the downside seem at present much more important than on the upside.

Baseline scenario: Our baseline scenario is one of "policy adjustments without further crisis". As in our Fall 2010 outlook, growth slows markedly in 2011 from a very rapid pace in 2010; and a two-speed world expansion persists through to 2013, with growth in EMEs far exceeding that in advanced economies. While avoiding a recession, advanced economies continue to grow at a tepid rate in 2012 (instead of gaining momentum as we expected last fall). Growth in Japan rebounds as the "tsunami effect" disappears and reconstruction proceeds, but the Euro area barely grows, whereas output in the United States and Canada advance at essentially the same pace as in 2011. *In the event of appropriate measures and policy adjustments to support growth and defuse sovereign debt crises, weak growth rates during the first half of 2012 would start picking up in the second half of the year and continue in 2013 as the effects of such measures bear fruit and confidence improves*. The soft patch in advanced economies contributes to somewhat slower growth in EMEs in 2012. Along with flat or lower commodity prices, this attenuates inflationary pressures.

Recession Scenario: A number of factors (which are essentially political rather than economic in nature) may considerably worsen the baseline scenario. A collapse of confidence in the ability of European policy makers both to avoid disorderly debt resolution with severe contagion and to implement reforms to improve competitiveness and growth, could trigger extreme turbulence in financial markets and a sharp deterioration of financial conditions. This could cause more than a mild recession in Europe and easily move the US economy from its "stall speed" into recession. In the United States, excessive short-term fiscal tightening and a drop in confidence may emerge from a failure to reach a bi-partisan agreement on a medium-term consolidation plan. Such policy failures in Europe and the United States would severely depress annual output in advanced economies in 2012, slow growth considerably in EME's, depress commodity prices, and bring global growth to a crawl. Canada would be hit by the decline of external demand, the fall of its terms of trade and a loss of confidence. Output levels and employment in 2013 would remain well below those envisaged in our baseline scenario although the rate of growth would improve.

Balance: As of mid-November, it is a "crapshoot" as to how political forces are likely to play in Europe and the United States. Our view is that the baseline scenario is the more probable one, but not overwhelmingly so.

Baseline Scenario for Output Growth (%)

	2010	2011	2012	2013
Canada	3.2 (3.0)	2.1 (2.3)	1.9 (2.5)	2.9
United States	3.0 (2.7)	1.7 (2.3)	1.7 (3.0)	3.2
Euro area	1.7 (1.7)	1.5 (1.4)	0.2 (1.7)	1.5
China	10.4 (10.3)	9.1 (9.0)	8.5 (9.0)	8.7
World	5.1 (4.7)	3.7 (3.8)	3.1 (4.0)	3.7

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

Illustrative Recession Scenario for Output Growth (%)

	2011	2012	2013
Canada	1.8 (2.1)	-0.7 (1.9)	3.3 (2.9)
United States	1.6 (1.7)	-0.5 (1.7)	3.4 (3.2)
Euro area	1.4 (1.5)	-1.7 (0.2)	2.2 (1.5)
World	3.6 (3.7)	1.1 (3.1)	4.2 (3.7)

*Figures in brackets are from the baseline scenario.

Some Implications for Canadian Business

With excess capacity prevailing through 2013 in both base and recession cases, policy interest rates in developed economies will remain very low for that period, as will high grade corporate bond rates. It could well be mid-decade before we see a more "normal" yield curve. Meanwhile, credit spreads are likely to widen in the short term. Bank lending is likely to become less available as banks adjust to meet higher regulatory standards and reduce risk. In view of the weaker economic prospects, housing prices are more likely to fall and mortgage supply may become more restrained. Even under our baseline scenario, prospects for a reduction in the unemployment rate have dimmed with negative consequences for future consumer confidence. In our recession scenario, unemployment increases and confidence weakens further. Either scenario points to relatively slow spending by households in the short term. Fiscal tightening, largely through cuts in government spending growth, will also likely moderate domestic demand expansion. Inflation in mature economies will be well contained through 2013.

In the projected environment of modest or very slow global growth over the next year, competitive pressures are likely to intensify and it will more difficult to expand exports or displace competing imports without cutting margins, raising productivity or moderating wage growth. On the other hand, a somewhat less robust Canadian dollar should restrain further erosion of the competitiveness of Canadian producers. Barring unanticipated supply disruptions, energy and mineral prices should also be somewhat softer than previously anticipated, with a rebound in 2013 as global growth strengthens.

Our baseline scenario assumes no specific shocks to Canada, but the potential for them clearly exists (see next section on trade). Moreover, if a recession was to materialize in advanced economies, the aforementioned implications would become more severe. Already-constrained Canadian governments, notably Ontario, could have to undertake more fiscal austerity in order to avoid credit downgrades.

Finally, we note that 2012 will be a year in which political factors have an enormously important impact on government policy and business confidence. Elections in the United States and Europe, and impending regime change in China, clearly imply heightened political uncertainty. In this context, no progress is likely to be made in resolving fundamental global imbalances or dealing with currency misalignments.

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Trade Issues

Against this uncertain background in the global economy, the outlook for world trade is also uncertain and worrisome, both with respect to the fight against protectionism, and for any early movement towards liberalization through the successful conclusion of the WTO's Doha Round of trade negotiations.

At their meeting in Seoul last November, the G20 Heads of State and Government stressed their commitment "to keeping markets open and liberalizing trade and investment". In stark contrast, the October 25 monitoring report from the WTO, the OECD and the UNCTAD regarding trade measures taken by G20 governments between May and November provides the gloomiest assessment since monitoring began in the wake of the 2008 financial crisis. The Heads of the three agencies note in their introduction that "Trade protectionism is gaining ground in some parts of the world as a political reaction to current economic difficulties." They go on to say "The situation is not yet alarming, but it is clearly adding to the downside risks to the global economy." In Cannes on November 4, the G20 leaders simply reiterated their earlier commitments "to avoid protectionism and not turn inward".

Regarding the WTO negotiations, the G20 has finally backed off its oft-repeated exhortations to finish the Doha Round. They really had no choice in the face of WTO Director-General Pascal Lamy's October 21 acknowledgment to WTO heads of delegation that the Round is "at an impasse" and that "as a consequence, it is unlikely that we will conclude the negotiations on all elements of the Doha agenda in the near future." Instead the leaders agreed "to stand by the mandate" of the negotiations and directed their Ministers "to pursue in 2012 fresh, credible approaches to furthering negotiations". Importantly they have also asked Ministers "to engage into discussions on challenges and opportunities to the multilateral trading system in a globalised economy" and report back to the next Summit. These directions provide much needed input for deliberation at the WTO's biennial Ministerial Conference in Geneva in December.

The disconnect between G20 words and actions (witness the US Administration's effort to include "Buy America" provisions in its "jobs" legislation) is disturbing. So too is the rise of "green protectionism", whether in the form of the European Commission's move to implement a low carbon fuel standard that would create an arbitrary and unjustifiable discrimination against synthetic crude oil made from Canada's oil sands, or Ontario's "Buy Ontario" preference policy for green power producers benefitting from above-market Feed-in Tariffs.

In Canada, the majority Harper government has identified its ambitious trade negotiations agenda as a key part of its jobs and growth strategy. Efforts with the US to enhance perimeter security and economic competitiveness and to foster improved regulatory cooperation appear to be making good progress.

Negotiation of a comprehensive agreement with the EU has progressed well, and will probably enter the final phase in the first half of 2012. Clinching a deal with the EU is a critical test. The prize is a big one, but if the government can't realize the objective, none of our other partners will take our overtures seriously. Failure could have very negative consequences because there is quite a bit of talk south of the border about the US doing a deal with the EU.

Negotiation of a comprehensive economic partnership agreement with India is underway. A joint study on the benefits of free trade with Japan may lead to the launch of actual negotiations in the coming months. Efforts to consider how to improve the framework for the conduct of trade and economic relations with China have been engaged. Exploratory discussions have been initiated with Mercosur (Brazil, Argentina, Uruguay and Paraguay). Negotiations are also underway with several other partners.

On November 12 at the APEC heads of government meeting in Hawaii, Mr Harper formally expressed Canada's "willingness to join" the Trans-Pacific Partnership (TPP) negotiations. The US has identified these negotiations as being its new major negotiating objective. The US is touting the TPP as being the new "gold standard" for trade agreements, going beyond NAFTA, and setting a template for future cooperation in the Asia-Pacific area. It isn't yet clear on exactly what basis the other TPP participants would let Canada into the talks given concerns about Canada's lack of willingness to liberalize trade in dairy and poultry products.

This largely positive news needs to be tempered somewhat by the fact that the Harper government hasn't yet completed the negotiation of any major trade agreement. And, indeed, negotiations with South Korea, Canada's sixth largest trade partner in 2010, are at an impasse. This is particularly important because the US has now ratified its trade agreement with Korea, and American exporters will soon have a decisive preferential advantage over Canadian suppliers, particularly of agricultural products, in the Korean market. This development shows the downside of a "competitive liberalization" approach to the liberalization of international trade. It is fine when Canada negotiates an agreement first, with the consequent advantage over our competitors in other countries; but it is damaging when we fall behind in the negotiation of new trade agreements. The lack of any prospect for a conclusion of the WTO negotiations in the foreseeable future further aggravates the situation.

Intergovernmental Transfers

Following the weak short-term performance described in the first section of this report, Canadian real economic growth over the remainder of the decade should average a little over two percent per year. The projected level of growth, which is well below Canada's historic performance, is attributable to subdued US growth in the short term and to declining labour force growth in the medium term as our population ages.

This top-line story of moderate national growth masks very significant ongoing structural change in the global and national economy. Just as we are looking at two-speed global growth, so too we face two-speed growth in Canada, with stronger growth than average in the resource-rich provinces, and slower growth in central Canada and the Maritime provinces.

A "two-speed Confederation" is not a new phenomenon. During the 19th century, the Maritimes was the most prosperous region in Canada, with strong commercial links down and across the Atlantic. During the second half of the 20th century, Central Canada benefitted greatly from deep economic integration with the United States, particularly in manufacturing sectors like automotive, aerospace and information technology. What is new in the 21st century, is that the terms of trade and trade patterns are changing due to the relative decline of the US and the rise of Asia. These changes benefit primarily resource-rich Western Canada, while dampening growth prospects in Central Canada.

Projected base case provincial growth rates are shown in the table below. While the decade-long growth rates in all jurisdictions would be slightly lower in our pessimistic (recession) scenario, the interprovincial pattern would be similar. On the other hand, if real resource prices rise significantly over the decade, the disparities in provincial growth rates would be much greater.

The aging of the Canadian population and consequent slow growth of our labour force makes it imperative that government and industry focus on improving Canada's productivity performance. The corporate strategies for doing so will vary from industry to industry, and company to company, but generally must focus on the development of innovative products and services while managing unit costs aggressively. Governments in resource-rich provinces will have to focus on capital investments, both to facilitate the ongoing exploitation of their resource base, and to encourage industrial diversification. Governments in slow-growth central Canada face the even more daunting tasks of finding ways to facilitate the expansion of new service and manufacturing enterprises to replace the declining manufacturing industries that supported growth in the second half of the last century. This challenge is particularly acute in Ontario, as its economy is highly integrated with the declining "rust belt" states in the U.S. The federal government will be challenged to develop trade policies that both reduce barriers at the U.S. border and enhance access of Canadian firms to overseas markets.

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Base Case Projections of Nominal Compound Percentage Provincial Growth 2012-2020

Higher Growth	
Alberta	4.8
British Columbia	4.5
Saskatchewan	4.5
Newfoundland	4.5

Average Growth	
Canada	4.2
Manitoba	4.2

Slower Growth	
Ontario	4.0
Quebec	4.1
N.B., N.S., P.E.I.	3.5

As if these economic challenges were not enough, all governments in Canada face the fiscal challenge of reducing deficits over the first half of the decade to stabilize the ratio of public debt-to-GDP. All Canadians can expect some combination of poorer quality government services (longer waiting lists, larger classes, more potholes, etc), more and higher user fees and higher taxes. Slow-growth provinces will have to make much larger fiscal adjustments than the high-growth provinces, given their slower revenue growth, higher debt loads and greater current deficits.

The table below shows that slow-growth provinces will increasingly be unable to provide reasonably comparable services to those in high-growth provinces on the basis of their own-source revenues. This is particularly true for Ontario, where a high fraction of revenue growth is required to reduce the deficit to one percent of GDP over the next five years. Moreover, the province's per capita spending on public services is already below the national average. Hence the second great fiscal challenge involving the revision and renewal of the expiring federal-provincial fiscal arrangements.

A constitutionally entrenched principle of the Canadian union is that Canada should provide equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. The Federal government seeks to put this principle into practice through fiscal transfers to the provinces (and territories) currently totaling about $53 billion per annum for equalization, the Canada Health Transfer (CHT) and the Canada Social Transfer (CST). A little over 70 percent of these payments take the form of per capita cash transfers to all provinces to assist in the financing of health care, education and other social services (CHT and CST). The rest of them represents capped transfers to the lower income provinces to partially equalize fiscal capacities based on a formula that applies average Canadian tax rates to the provincial tax bases for four taxes - personal income tax (PIT), corporate income tax (CIT), consumption taxes (CT), and property taxes (PT) – as well as 50 percent of actual revenues generated from the exploitation of natural resources.

On a per capita basis, the principal beneficiary of *equalization* is Prince Edward Island, while Quebec receives the largest amount in absolute terms due to its large population. The

Cumulative Average Annual Nominal Growth 2012-2020 (Base Case)

	Own-source Revenues Growth %	Program Spending Room Growth**	Net Debt in 2010
	%	%	% of GDP
Federal	4.4	3.5	33.3
Alberta	4.7	4.1	(12.9)
Ontario	4.2	2.6	42.7
Quebec	4.1	3.6	49.9

** Assumes that federal and provincial deficits are reduced to 1% of GDP by 2017 and maintained thereafter, except in Alberta, where the budget is balanced by 2015, with insignificant surpluses thereafter cumulative impact of CHST and equalization federal transfer programs creates a per capita range of federal transfers from approximately $900 (Alberta) through $2100 (Quebec) to $3400 (PEI). In absolute terms, Ontario (with 39 percent of the national population) and Quebec (23 percent) are each receiving 30 percent of the transfers in the current fiscal year ($17.4 billion and $17.3 billion respectively).

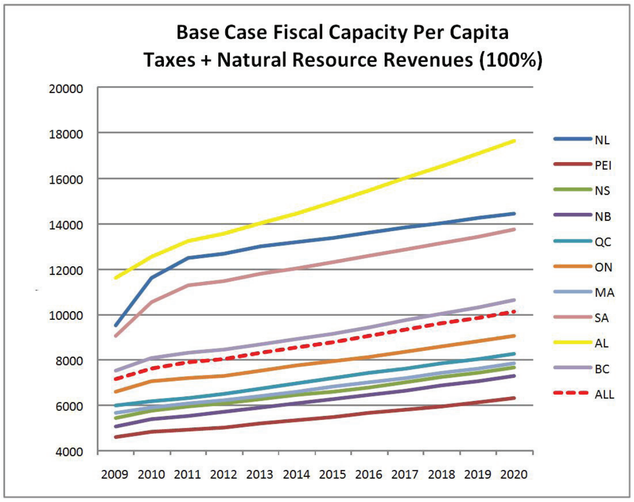
The pressures underlying the allocation of federal fiscal transfers in today's two-speed Canada mean it cannot, and will not, be "business as usual" in the years ahead.

Many Canadians (erroneously) perceive the system of federal transfers solely in terms of "equalization", believing the "Have" provinces of Ontario and in Western Canada support the remaining one-third of Canadians living in the "Have-not" provinces located east of the Ottawa River. The sudden rise of Newfoundland & Labrador to "Have" status has shaken the Atlantic Canadian stereotype, while the recent decline in Ontario's relative fiscal capacity to below the national average has exposed that the source of funds for federal transfers is *not* the "Have" provinces as such, but rather higher income taxpayers and profitable corporations located in all provinces (particularly Ontario, which constitutes "40 percent of Canada").

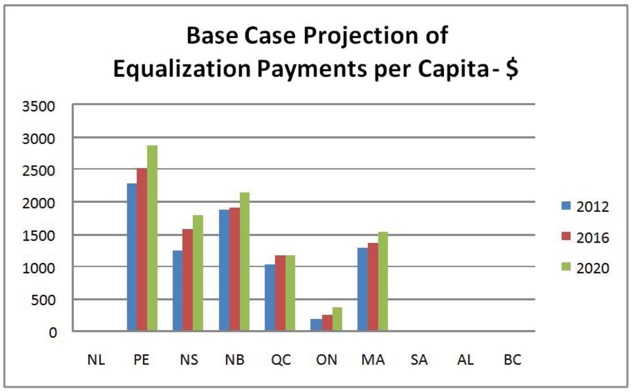
It is this decline in the fiscal capacity of Ontario relative to a national average raised by the capacity of resource-rich Western Canada (and Newfoundland) that is necessitating a fundamental re-think and reform of federal-provincial fiscal arrangements. For the shift in the position of Ontario and Newfoundland/Labrador means that equalization has moved from a longstanding situation where equalization payments flowed to six provinces containing one-third of the population to a less sustainable "new normal" where funds are going to six provinces with two-thirds of the population.

The extent of the political challenge and need for fundamental reform in a two-speed Canada can be seen through projecting provincial fiscal capacities, revenues, transfers and program spending to the end of this decade, and applying the current equalization formula.

Under the moderate growth base case, the gap in fiscal capacities between the current "Have" and "Have-Not" provinces will widen over the decade, with the highest income provinces of Alberta, Saskatchewan and Newfoundland and Labrador experiencing the highest rate of growth in nominal GDP per capita to 2020, and Ontario's per capita fiscal capacity falling further below the national average.



Payments under the existing equalization formula would narrow, but by no means eliminate this gap. (In fact, while it is possible to design arrangements that provide an adequate minimum level of income, seeking to equalize incomes is akin to a dog chasing its tail, particularly since the federal government lacks direct access to the resource revenue that contributes to the disparity.)



It follows that a central issue in the coming federal-provincial discussions will be the treatment of resource revenue, both non-renewable *and* renewable, in an increasingly carbon-constrained world.

The sale of non-renewable energy assets is less in the character of income generation than the conversion of a capital asset into another form of capital. Resource-rich provinces that commenced investing such capital funds in sequestered investment vehicles, not spending on current consumption, would substantially reduce their current fiscal capacity, and hence the national average. On the other hand, subsidized hydroelectricity prices reduce the profits of certain provincially-owned utilities, thereby reducing provincial fiscal capacity (as currently defined), and enabling larger equalization entitlements. The closure of most coal-fired power plants in Canada by 2030 will cause a significant increase in electricity prices in many provinces, but particularly Alberta and Saskatchewan. Recognizing the true value of hydro-electricity would substantially increase the relative fiscal capacity of hydro-rich provinces.

The pressures underlying the allocation of federal fiscal transfers in today's two-speed Canada mean it cannot, and will not, be "business as usual" in the years ahead. The importance of federal fiscal transfers to provincial fiscal plans means we are likely to witness a ratcheting-up of tension between the federal and provincial governments, and between the provinces, at a time when there will be a need for an unprecedented level of federal-provincial fiscal coordination and cooperation. Some of these tensions, such as those between Central and Western Canadian provinces, will be old and familiar. However, what is new is the potential for growing tension between Ontario and Quebec, as the former claims a growing share of federal transfers due to a relatively declining fiscal capacity. Such tensions suggest great care will have to be taken to avoid the current period of relatively placid federal-provincial relations becoming the proverbial calm before a sudden and dangerous political storm.

The Bennett Jones – Economic Outlook Fall 2011, takes into account all information available up to and including November 21, 2011.

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