Bennett Jones Economic Outlook

Fall 2012

Economic Growth: The Bumpy Road Ahead

David A. Dodge O.C., Richard Dion and John M. Weekes

Since our spring 2012 economic outlook, the crisis in the eurozone has worsened and growth in the emerging economies has fallen more than expected, with negative spillovers on the United States and Canada. Uncertainty about future policies and their effects remains pervasive and the risks to growth in the short term are still predominantly on the downside. Under the assumption that political compromises are achieved and major policy failures are avoided, advanced economies will experience subdued growth and emerging market economies (EMEs) a relatively robust expansion over the next two years, while commodity prices should remain at roughly current levels but experience greater volatility. The legacy effects of the financial crisis and recession continue to weigh on the global recovery through private-sector deleveraging and fiscal consolidation. However, a diminution of deleveraging, as private debt falls to more prudent levels relative to income and government deficits are contained, sets the stage for better growth in advanced economies around mid-decade.

Recent World Economy Dynamics

After a solid rebound in 2010, global growth faltered in 2011 and has fallen further in 2012, with the euro area experiencing an absolute decline in activity this year and the EMEs a marked slowdown in growth. Private-sector deleveraging and tight fiscal policy have contributed to hold back growth in advanced economies, as was to be expected in the wake of a severe financial crisis. In addition, the spillovers of the eurozone shock on global growth, the cooling impact of the 2010-11 tightening of monetary and credit policies in EMEs and, to a lesser extent, a rebound in oil prices from their recession lows have constituted important headwinds to the global recovery. Easier monetary policies in advanced economies and still solid growth in the EMEs have mitigated these adverse factors, but increasingly less so as the euro crisis has worsened and uncertainty about future policies and their effects has become more pervasive.

Recently, EMEs have eased their economic policies, the U.S. housing market has started improving, albeit from a very depressed level, and monetary policy in advanced economies has been further eased, including in the United States, where a new round of unconventional monetary policy (QE3) is being implemented, and in the eurozone, where a new sovereign bond-purchase program, conditional on a macroeconomic adjustment or precautionary program with the EFSF/ESM (European Financial Stability Fund/ European Stability Mechanism), is ready for implementation. In principle, all this should help stimulate domestic demand, employment and confidence, with positive effects on international trade and thus external demand. Nevertheless, considerable uncertainty persists about the viability of the eurozone (given the policies and reforms still needed to tackle its banking, fiscal and competitiveness problems), about how the "fiscal cliff" in the U.S. is going to play out, and about how successfully policies will support growth in large EMEs. While monetary policy announcements have fed a financial rally in late summer, uncertainty has continued and still deters business investment and hiring, especially in the eurozone where it contributes to tighter credit standards.

Short-Term Outlook: 2012-2014

Looking ahead, many scenarios may unfold in the short term, ranging from recession in the advanced economies accompanied by low growth in EMEs in the event of major policy failures, to a take-off in global growth reminiscent of past recoveries in the event of unexpectedly decisive policy moves. A more probable outcome is that supportive policy actions and the absence of oil price escalation allow confidence to improve, private spending and hiring to pick up, and global growth to stabilize and then rise towards its potential rate. By mid-decade, a rapid diminution of deleveraging in advanced economies, or even a re-leveraging in some cases, could set the stage for a period of above-trend growth.

In this scenario, inflation is well contained, short-term interest rates remain very low to the end of 2014 while unconventional monetary policy tends to lower long-term interest rates and boost the price of risky assets. Commodity prices may lose some ground in the near term inasmuch as growth prospects are questioned, but are expected nonetheless to remain elevated although subject to considerable volatility.

Consistent with this baseline scenario, global growth averages about three percent in both 2012 and 2013 before picking up to 3.5 percent in 2014. The euro area experiences a decline in activity in the final three quarters of 2012 and a tiny rebound in 2013 when a pick-up in exports in response to the earlier depreciation of the euro and a modest strengthening of external demand overcomes the drag exerted by domestic demand. Deleveraging by households, governments and the financial sector weighs on domestic demand, which nonetheless begins to expand in 2014 as confidence gradually improves and financial conditions ease somewhat in response to tentative steps taken toward a banking union and greater fiscal integration.

U.S. growth remains close to two percent during the second half of 2012. We judge that there will be some political compromise related to the fiscal cliff issue. In this compromise scenario, growth slows in early 2013 as a result of a tightening of fiscal policy but, abetted by the recent easing of monetary policy and diminishing household deleveraging, subsequently picks up markedly and for the year as a whole averages slightly above two percent. Fiscal drag cuts real GDP growth by about 1.5 percentage points in 2013 (and 2014), 0.5 points more than in 2012 but considerably less than the approximate three points (by end-2013) implied by the full potential fiscal cliff according to the U.S. Congressional Budget Office. Supporting stronger growth during 2013 are exports, as external demand picks up; business investment, as uncertainty diminishes and businesses start activating their large cash flow; and residential investment, as employment gains momentum, home vacancies diminish and construction gradually rises towards levels consistent with demographic demand. Growth decelerates somewhat during 2014, but for the year as a whole averages slightly above three percent.

Growth in China remains close to eight percent throughout the period 2012-2014, significantly lower than in 2011, largely because of weaker growth in exports and investment, but more in line with the projections of the latest five-year plan. Recent monetary and fiscal policy easing, including accelerated approval of public infrastructure projects, helps buttress domestic demand growth while exports pick up somewhat in 2013 as external demand firms up. We expect a rather modest real appreciation of the renminbi. On the structural side, China still faces the challenge of managing the transition to consumer-led growth and strengthening its financial system.

Canada's growth remains relatively close to an average of 2.2 percent per year over the period 2012-2014. Exceptionally accommodative financial conditions, favorable terms of trade and some easing of the federal government fiscal drag provide support to domestic demand growth. A strengthening of the sectors in the U.S. economy that specifically drive Canadian exports offsets the negative impact of Canadian industries'

Short-Term Prospects for Output Growth (%)

	2011	2012	2013	2014
Canada	2.4 (2.5)	2 (2.4)	2.2 (2.4)	2.5
United States*	1.8 (1.7)	2 (2.3)	2.3 (2.5)	3+
Eurozone*	1.5 (1.5)	-0.5 (-0.4)	0.2 (0.9)	1
China	9.2 (9.2)	7.7 (8.2)	7.7 (8.5)	8
World	3.8 (3.8)	3 (3.2)	3+ (3.5)	3.5

*This projection assumes that political compromise is achieved in the United States and the eurozone. Figures in brackets are from the Bennett Jones Spring 2012 Economic Outlook.

lack of cost competitiveness. The Canadian dollar is likely to remain near parity with the U.S. dollar, supported by commodity exports, safe-haven capital flows and spillovers from global monetary policy. Other factors constraining growth in Canada include a recent overbuilding of housing (especially condos) in some cities, which should lead to a decline in housing investment over the next two years, and high household debt, which should hold back consumption growth. Moreover, weak provincial finances (especially in Ontario and Quebec) constrain public investment and induce labour relations problems. Key challenges facing Canada in the years ahead therefore include improving productivity growth and cost competitiveness, reducing household indebtedness relative to income, and strengthening provincial finances.

Major Risks

The key risks to our fall outlook are predominantly on the downside and mostly related to major policy failures. First, the U.S. Congress may fail to resolve the fiscal cliff issue and the resulting fiscal drag would bring the U.S. economy to a halt in 2013, if not into recession, with adverse spillovers on the rest of the world. Second, the banking and sovereign debt crisis in the eurozone may get far worse, deepening the recession in the periphery countries and bringing material output losses in the rest of the world. Third, the transition to a more balanced economy in China may falter and easier policies may fail to support growth, again with negative spillovers on the rest of the world. Finally, the possibility of oil price hikes remains an additional downside risk to global growth in view of ongoing geopolitical risks and other potential sources of oil-supply disruption. On the other hand, one upside risk for 2014 is the possibility that a surprisingly good resolution of fiscal issues generates more confidence, stronger business investment and faster growth in the advanced economies than factored in our baseline scenario.

Some Implications for Canadian Businesses

As pointed out in our spring 2012 outlook, strong balance sheets, combined with very low financing rates and a strong Canadian dollar, provide favourable conditions for the acquisition of new capital goods and related investment in efficiency improvement and product innovation. The benefits of more investment should be increasingly felt as aggregate demand growth in the United States starts picking up during 2013. In the next year Canadian businesses face a pressing competitive challenge arising from a strong Canadian dollar (likely to remain near parity), relatively weak productivity growth, accelerating labour costs (particularly in Western Canada), and more severe shortages of some skills across the country. Our view is that current pessimism is unwarranted. By mid-decade, we should be in the early stage of a longer-run cycle of better growth.

Trade Issues

The outlook above is premised on no change in trade policy that would have significant effects on global growth over the next two to three years. While the Doha Round appears to be dead, there is considerable bilateral activity to reduce trade barriers.

In his October 31 "Summary of WTO Report on G20 Trade Measures," Director-General Pascal Lamy observes, "There has been a slowdown in the imposition of new trade restrictive measures by G-20 economies over the past five months. Nevertheless, the new measures are adding to the stock of restrictions put in place since the outbreak of the global crisis, most of which remain in effect."

Ominously he adds, "At a time of continuous economic difficulties, trade frictions seem to be increasing. They are reflected not only through trade remedy and dispute settlement cases under the WTO, but also through decisions affecting foreign investment and participation in infra-structure-related government procurement programmes."

Noting that the prospects for the global economy are highly uncertain he observes, "The WTO Secretariat has recently revised downward its forecast for world trade growth in 2012 to 2.5% from its 3.7% forecast issued in April 2012. The volume of trade growth in 2013 is now forecast to be at 4.5%, still below the long-term annual average of 5.4% for the last 20 years."

On the trade negotiations front there are spluttering efforts in the WTO to salvage pieces of what was on the table in the Doha Round but the odds are long that any of this will happen. On the other hand efforts to launch a plurilateral negotiation to liberalize trade in services within the WTO are making progress. These negotiations will probably get underway in the New Year.

Outside the WTO much is happening in what has become known as *competitive trade liberalization* through bilateral and regional negotiations—*competitive* because the process puts considerable of pressure on countries to be the first to negotiate agreements so that they enjoy an advantage by achieving barrier-free access ahead of their competitors. Failure to move quickly can result in negative discrimination and loss of markets.

Canada and Mexico join the United States and eight other countries as full participants in the 15th round of the TransPacific Partnership negotiations in Auckland in December. It is expected that these negotiations will intensify in 2013. Other countries, notably Japan and Thailand, are reported to be interested in joining the talks.

The Canada-EU comprehensive free trade negotiations appear to be entering their crucial final phase and may well conclude in the coming month or two.

The first full round of what is known as the Canada-Japan Economic Partnership negotiations began in Tokyo on November 26.

These developments offer hope that the Harper government's trade negotiations agenda is working.

Efforts to revive the stalled FTA negotiations with South Korea, however, have not yet met with success.

It seems increasingly likely that the US and the EU will enter free trade negotiations in 2013. An agreement between these two major powers would alter the trade landscape dramatically. It might even trigger interest in trying to consolidate the various bilateral and regional achievements into a multilateral agreement in the WTO. This could be a subject of focus for the next Director-General of the WTO, who will take office September 1, 2013, following a selection process beginning on December 1.

Practice Contacts

David A. Dodge O.C.
613.683.2304
dodged@bennettjones.com

Richard Dion
613.683.2312
dionr@bennettjones.com

John M. Weekes
613.683.2313
weekesj@bennettjones.com

This paper was prepared by David Dodge, former Governor of the Bank of Canada, Richard Dion, former Senior Economist with the Bank of Canada, and John Weekes, Canada's Chief Negotiator for the North American Free Trade Agreement (NAFTA). All are Senior Advisors with Bennett Jones and members of the Bennett Jones Government Affairs & Public Policy Group.

Firm Contacts

Chairman and CEO
Hugh L. MacKinnon
416.777.4810
mackinnonh@bennettjones.com

Calgary Managing Partner
Perry Spitznagel Q.C.
403.298.3153
spitznagelp@bennettjones.com

Toronto Managing Partner
Stephen W. Bowman
416.777.4624
bowmans@bennettjones.com

Edmonton Managing Partner
Enzo J. Barichello Q.C.
780.917.4269
barichelloe@bennettjones.com

Ottawa Contact Partner
Edward S. Goldenberg
613.683.2301
goldenberge@bennettjones.com

Dubai Managing Partner
Timothy N. Ross
+971 4 454 0888
rosst@bennettjones.com

Abu Dhabi Managing Partner
James J. McDermott
+971 2 493 9022
mcdermottj@bennettjones.com

Doha Contact Partner
David Silver
+971 4 454 0844
silverd@bennettjones.com

Beijing Representative Office Contact
Margaret Cornish
+86 10 6535 0126
cornishm@bennettjones.com