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Economic Outlook

Fall 2018

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Section I:
Global Growth to 2021

Recent Developments

The world economy has expanded at a solid rate in the first three quarters of 2018, although growth has been somewhat slower and less synchronized than during 2017. In the first half of the year, growth in OECD countries as a whole lost some of the strong above-trend momentum experienced throughout 2017. The slowing was most pronounced in the euro area where annualized growth fell from 2.7% during 2017 to 1.7% during the first half of 2018. Growth in other advanced economies was also weaker in the first quarter than in 2017, but did rebound strongly in the second quarter, notably in the United States and Japan. In 2018-Q3 growth continued to be brisk in the United States at 3.5% while growth in the euro area receded further to 0.7%. China and India continued to expand at a rapid pace in the first three quarters. In China, however, the manufacturing purchasing managers' index fell in October to a level that barely exceeded the threshold that separates expansion from contraction, signaling that slower manufacturing activity is to be expected in the fourth quarter. Stronger oil prices benefited oil-producing countries this year, notably Russia. In contrast, growth in Brazil has been very anemic during the year, hampered by strikes and political uncertainty, and in Argentina activity has plummeted.

Inflation in the year to August was about 1.0% (core CPI) in the euro area and 0.2% in Japan, both still far below target. In the United States, core consumer-expenditure (PCE) inflation, the measure preferred by the Federal Reserve, continued to increase in the first three quarters of 2018, reaching 2.0% year-on-year in both the third quarter as a whole and September. Core CPI inflation was 2.1% in October and 2.2% in August and September after rising from 1.8% in February to 2.4% in July. While the pace of hourly wage gains in the United States has picked up since last April, wage increases remain surprisingly moderate in light of unemployment rates that have reached their lowest levels since the end of 1969.

Monetary policy remains accommodative. The European Central Bank (ECB) and the Bank of Japan have held their policy interest rates at record low levels. Both continued quantitative easing although the ECB started cutting the volume of its monthly bond purchases in October. In contrast, the Federal Reserve has continued the process of interest rate normalization, lifting the target federal funds rate by another quarter percent in June and again in September, to 2.25% (upper limit), and it continued also the process of reducing the size of its balance sheet.

Commodity prices in U.S. dollars, as measured by Bank of Canada indexes, rose considerably in April and May 2018 to reach a 3 1/2–year peak before retreating to their lowest levels since mid-March 2017 by early November 2018. Weighing on commodity prices have been less certain growth prospects for China, increases in Chinese and Mexican tariffs against U.S. agricultural exports, and a significant appreciation of the U.S. dollar. International oil prices, on the other hand, were relatively firm all the way to late October, with WTI prices hovering around the level of US$70 level reached in May. This firmness was buttressed by current and anticipated very limited spare output capacity in the oil market, expected strong oil demand and uncertainty about future oil supply expansion after the production loss from Venezuela and the impact of sanctions on Iran.

In the first half of November, however, WTI prices sunk to the mid US$50s as concerns about oil supply abated due to stepped-up OPEC and U.S. shale production and increased Iranian supply due to temporary waivers to key consumers of Iranian oil. At the same time, an unusually sharp reduction in refinery runs temporarily reduced oil demand and increasing concerns about the strength of future global demand for refined products, due to growing signs of weakening global growth, added to the bearish sentiment about future oil prices. Meanwhile the Western Canada Select (WCS) heavy oil price discount to the WTI price widened to historic highs between May and October. This was attributed to a combination of rising oil sands production, full oil export pipelines, lack of storage capacity in Alberta, a slow uptake in crude-oil-by-rail shipments, and, for a while, reduced U.S. demand amid refinery maintenance. While some of those factors may abate, pressure on price discounts will remain high until significant new capacity is added to connect producers to markets.[1]

The **U.S. dollar exchange** rate has appreciated between mid-April and early November 2018, by 9% on a trade-weighted basis (broad index) and against the euro, by 11% against the renminbi and by 4% against the Canadian dollar. This appreciation fundamentally reflects both the strength of the U.S. economy and rise of U.S. interest rates relative to the rest of the world as well as intensifying concerns about Brexit, Italian budget issues and weakening Chinese growth. In June and September both the United States and China announced and implemented increases in tariffs against each other over an increasing range of imports (see Section II on international trade).[2] These trade frictions have intensified concerns about Chinese growth and depressed both the renminbi and Chinese equity markets.

Equity prices have become volatile. The S&P 500 index of U.S. stock prices rose by 11% between early May and October 3 and then fell by 10% to October 29. Volatility continued in November. The S&P/TSX Composite index and several other stock exchanges experienced considerable decline during this fall. Some have considered that U.S. equities had become overvalued and hence were due for a downward price correction. The triggers for the recent volatility in stock markets include heightened worries that U.S. corporate earnings could weaken as the current cycle becomes long-in-the-tooth, apprehension of a coming economic slowdown in Asia, and fear of rapid interest rate increases.[3]

Global Economic Outlook

The relatively rapid global expansion of 2017 and 2018 is coming to an end. The world economy is expected to slow to its potential rate of growth in the next two years. This is a view that we held last spring as well. What has changed since then, however, is that the strong momentum observed during 2017 lost steam faster during 2018 than we expected. Moreover, a trade dispute between the United States and China took a surprisingly bad turn in June and September at the instigation of the United States. Projected growth rates for 2019 and 2020 are now somewhat lower than we envisioned last spring,[4] primarily reflecting the expected global impact of increased trade tariffs by the United States against China and the consequential reaction of the Chinese authorities. While the rate of growth of the global GDP will decline significantly over the next two years, we do not think that the global economic and financial headwinds that we anticipate are sufficiently severe in and of themselves to cause a global recession.

Base-Case Projection

Annual **global growth** is projected to recede from the above-potential rate of 3.7% in the last two years to 3.5% in 2019, 3.4% in 2020 and 3.3% in 2021, its trend rate at that time (Table 1). Much of the projected slowdown originates in the advanced economies, which now operate at or near capacity and could not grow much faster than their potential rate beyond 2019 without risking an intensification of inflationary pressures. Going forward, potential growth in the advanced economies is expected to be held back by a continuation of the disappointing labour productivity growth experienced in the last several years and by the negative impact of population aging on labour force growth. Meanwhile, aggregate demand growth in the advanced economies will be driven down to its (lower) potential rate in the short term primarily due to the run-off of the effects of the 2018 U.S. fiscal stimulus and the normalization of U.S. monetary policy. U.S. and Chinese tariff increases will accentuate the policy-induced slowdown in advanced economies, as probably will ongoing political issues in Europe, at least for a while. China will also see its growth rate diminish over the short term as authorities are likely to offset through stimulative policies only part of the drag on growth stemming from further rebalancing of the economy and the trade war with the United States.

Our economic projection is based on the assumption that the WTI oil price will fluctuate around US$60-65 in the short term, much as in our Spring Outlook. We interpret the steep price fall in the first half of November as a temporary movement resulting from both a strong short-term supply increase in anticipation of the U.S. sanctions on Iranian oil and a downward adjustment in expectations of oil demand growth. While we expect global oil demand to grow at a slowing pace going forward in concert with gradually lower growth in global activity, we assume that global oil supply will adjust to that slower pace of demand and keep prices in the range of US$60-65 on average over time. We anticipate much volatility around that level in reaction to industry news, geopolitical developments, revised economic forecasts, and delayed adjustment of oil supply to changes in demand.

Table 1

SHORT-TERM PROSPECTS FOR OUTPUT GROWTH (%)*

	2018 World Output Share (%)[2]	2017	2018	2019	2020	2021
Canada	1.4	3.0	2.1(2.1)	2.0(2.1)	1.8(1.8)	1.7
United States	15.2	2.2	2.9(2.3)	2.5(2.6)	1.8(2.0)	1.8
Euro Area	11.4	2.4	1.9(2.2)	1.6(2.0)	1.7(1.7)	1.5
Japan	4.2	1.7	1.1(1.2)	0.9(1.2)	0.3(0.3)	0.5
Advanced Economies[1]	32.2	2.2	2.3(2.3)	2.0(2.1)	1.6(1.7)	1.5
China	18.7	6.9	6.6 (6.6)	6.2(6.4)	6.0(6.3)	5.8
India	7.7	6.7	7.5(7.5)	7.5(7.5)	7.5(7.5)	7.5
Rest of World	41.4	2.8	2.8(3.0)	2.8(3.2)	2.8(3.0)	2.8
World	100	3.7	3.7(3.8)	3.5(3.8)	3.4(3.5)	3.3

* Figures in brackets are from the *Bennett Jones Spring 2018 Economic Outlook*.

[1] Weighted average of Canada, United States, euro area and Japan.

[2] Shares of world output are on a purchasing-power-parity basis.

U.S. growth is projected to decelerate from 2.9% in 2018 to 2.5% in 2019 and 1.8% in 2020 and 2021, a profile only slightly lower than in our Spring Outlook. The much-above-potential growth expected in 2018 and 2019 is buttressed by the 2018 fiscal stimulus, less restrictive regulation, high confidence levels and a buoyant labour market. All these underpin continued growth in consumption spending and business investment. Growth in aggregate demand nevertheless declines gradually towards its potential rate of 1.8% by the first half of 2020 as the economy adjusts to: (a) higher interest rates, (b) a stronger U.S. dollar, (c) a run-off of the effect of the existing fiscal stimulus,[5] and (d) the negative impact of increased trade barriers. As a first approximation, escalating trade barriers between the United States and China would cut U.S. real GDP growth by 0.2 percentage points by the end of 2020.[6]

U.S. price and wage inflation has remained surprisingly tame this year in light of the fall in the unemployment rate to historical lows. While some analysts anticipate a stronger response of prices and wages to labour market developments in the future, as in our Spring Outlook, we judge that a sudden burst of inflation has a low probability of occurring in 2019. Thus, there is a low risk that the U.S. policy interest rate will rise by significantly more than the already anticipated 100 basis points by early 2020. Nevertheless, mounting trade frictions and the collateral threat to global supply chains create a small upside risk to cost and price inflation in the United States in the short term.

With the U.S. economy currently at capacity and core inflation at about the 2% target, we expect the Federal Reserve to increase its target federal funds rate to a "neutral level" of 3.0 to 3.5% by the end of 2019, with little chance of a further increase thereafter. This roughly 100 basis points increase from the current level would be enough to constrain core inflation to be close to the 2% target over the short term. There is limited potential for some further appreciation of the U.S. dollar on a trade-weighted basis in 2019, given the projected relative strength of the U.S. economy and widening policy interest rate differentials relative to some other currencies. Yields on 10-year U.S. Treasuries is likely to top out at 3.5% around the end of 2019.

Euro area growth is projected to be 1.9% in 2018 compared to 2.4% in 2017 and to converge toward a potential rate of about 1.5% by 2021. Much of the quarterly growth slowdown in the first three quarters of 2018, to about 1.4% from 2.7% during 2017, stems from weaker export growth which was probably caused in part by an earlier appreciation of the euro. There was also a slowdown in household consumption despite considerable cumulative improvement in the eurozone labour market. In both Germany and France, confidence levels have receded since early 2018 with little prospect for a rebound in the current uncertain European and global context. In Germany, a change in emissions regulation in the car industry, whose negative effect on growth is expected to be temporary, contributed to slightly negative growth in 2018-Q3 and depressed business surveys in October. In Italy, there was no growth at all in the third quarter amid political turmoil and financial volatility. Consequently, our projection assumes that quarterly real GDP growth in the euro area will remain subdued at the end of 2018 before rebounding to above-potential rates in the first half of 2019. It will then recede gradually to its potential rate over the next year as elevated political uncertainty in Europe, slowing global growth and trade, and a late withdrawal of monetary stimulus weigh on the eurozone expansion. As a result of this quarterly profile, annual growth rates come out at 1.9% in 2018, 1.6% in 2019, 1.7% in 2020 and 1.5% in 2021. Growth remains lower than in our spring projection throughout because of weaker global demand for EU exports and greater political uncertainty (Italy and Brexit). Policy interest rates are not expected to be lifted from their 0% level before the end of 2019, although the ECB announced it would terminate its monthly bond purchases at the end of 2018. If growth continues to be anemic for a while, the ECB may well continue or resume its bond purchase program in 2019.

Our projection for **Japan** is slightly weaker than in our Spring Outlook, with growth rates of 1.1% in 2018, 0.9% in 2019, 0.3% in 2020 and 0.5% in 2021. The effect of the global slowdown in 2020 will be accentuated by a planned hike in the value-added tax in October 2019. Growth in Japan is projected to be below its potential rate of 0.5% in 2020 before returning to it in 2021. The tax increase in 2020 would have permanent effects on the levels of consumer prices and real disposable income but not on the growth of real consumption and GDP, hence the rebound in growth projected for 2021.

Growth in **China** is projected to be 6.6% in 2018, but to fall to 6.2% in 2019, 6.0% in 2020 and 5.8% in 2021. Two main factors cause this slowdown. First, based on estimates produced by the Bank of Canada, Morgan Stanley, Moody's Investors Services and some Asian analysts, the tariff increases announced by the United States would directly reduce real GDP growth in China by about 0.5 percentage points by the end of 2020.[7] This does not include potentially significant adjustment and reallocation costs that would reduce growth further. A weaker yuan should, nevertheless, provide some support to growth via net export gains.

Second, rebalancing of the economy to achieve more sustainable growth over the longer run is set to continue and should entail a slowdown in growth in the absence of counteracting policy measures. As advocated at the 19th Congress last year, Chinese authorities would take steps to emphasize "quality" rather than "quantity" of growth. This would involve a continued and perhaps accelerated shift from industrial production to services, from physical infrastructure investment to consumption, investment in high technologies and intellectual property products, including AI.

In the recent past, Chinese authorities have had the room and the willingness to do what it takes to achieve a target growth rate for the economy, currently at 6.5%. The question now is whether and to what extent they will be ready to adjust downward this growth target going forward in the face of the trade headwinds, the rebalancing objective, and high levels of debt and credit risk. Three years ago we expected that Chinese authorities would let growth recede to 5% within a few years in the interest of promoting a rebalancing of the economy and limiting a buildup of debt and credit risk. Our judgment was premature at the time. But we expect that Chinese authorities now will give more weight to these considerations going forward and let growth slip below the current official target to about 6% by 2020. A number of economic reasons would support such a move. First, potential growth in China is expected to decline over time because of adverse demographics and a shift to lower-productivity services production and should probably be well below 6.5% by 2020.[8] Second, policies that stimulate growth by boosting credit expansion raise already high debt levels and increase credit risk. As well, stimulating physical infrastructure investment runs counter to the objective of rebalancing the economy without significantly improving potential growth, given that the marginal return to new infrastructure is decreasing and that so much investment has already taken place. In addition to these economic reasons for accepting lower growth, the trade war with the United States provides political cover to Chinese authorities vis-a-vis its public.[9] This being said, the central government has the fiscal capacity to prop up the economy and should be expected to provide a cushion against the effects of the new tariffs. Indeed, policies have recently become more stimulative amid signs of slowing growth and in all likelihood will be loosened further going forward, but not to an extent that would prevent growth from falling significantly below its recent pace in the years ahead.

We expect tighter financial conditions, slowing growth in China and large advanced economies, and flat or declining real commodity prices to hold back growth in the **rest of the world**. Emerging and developing economies that have significant debts in U.S. dollars are expected to face a reduction in capital inflows that would otherwise support growth. This being said, India is set to continue to grow strongly at 7.5% over the next three years. Fast-growing East Asian emerging economies should expand at a somewhat slower rate going forward due primarily to weaker growth in China. While the economies of Brazil and Mexico are expected to gain some momentum after a disappointing performance in 2018, the rest of the advanced economies and emerging Europe are projected to lose momentum in concert with slowing growth in the large advanced economies and China. Growth in other emerging and developing economies is projected to slightly exceed its 2018 pace.

Risks to the Global Outlook

There are two key issues regarding which upside and downside risks to our projection are evenly balanced: first, U.S. inflation and interest rates, and second, the limited size of the additional fiscal boost to growth in 2019 flowing from last year's U.S. tax cuts and expenditure increases. We consider that the risk of a substantial burst of U.S. inflation in 2019 and 2020 is low and hence that the risk of an increase of substantially more than 100 basis points in the Federal Reserve's target interest rate is low. We also judge that the risk of additional fiscal measures in the United States being passed in 2019 and 2020 is relatively low especially in light of the Democrats' gain of a majority in the House, and that the stimulative demand impact of last year's fiscal measures will fade out by the end of 2019.

That said, we see two possible upside risks to our projection. First, growth in China could be stronger than we envisage if authorities show more readiness than we expect in keeping growth, at or close to, their current official target of 6.5% through fiscal and monetary stimuli, as they have done in the past. This would have positive short-term spillovers on global growth and commodity prices. Second, there is always a chance that productivity growth in the advanced economies might improve materially over the next three years, thereby raising potential growth. The persistence of modest productivity growth in the face of stronger investment in recent years points, however, to a limited upside risk to trend productivity growth in the short term. In the United States, labour productivity growth has narrowly fluctuated around 1.2% on a year-on-year basis since 2016-Q3, with no sustained pick-up even though business investment was growing at a robust pace.

While we acknowledge these two limited upside risks to growth, there are a number of specific downside risks to our short-term outlook besides geopolitical risks related to the Middle East, Russia, or Asia (the Korean Peninsula and South China Seas).

First, while our base case assumes that the recent tariff increases imposed by the United States and China stay in place through to 2021, in fact they may escalate further and have a larger negative net impact on growth than projected.

Second, the current plan for Brexit and EU negotiations with Italy over budget issues could end up in failure. This failure would have adverse effects on financial stability and growth in Europe, with spillover in the rest of the world.

Third, U.S. interest rate normalization, the expected fading of the U.S. fiscal stimulus impact on corporate earnings, and unfavorable geopolitical issues, including trade restrictions, could induce a re-pricing of asset prices, especially U.S. equities, a process which may have started in late October. A big correction and large collateral decline in financial wealth might temporarily bring slower growth than expected in the short term.

Fourth, increased U.S. interest rates and further strengthening of the U.S. dollar may slow growth more than currently anticipated in our base case in a number of emerging economies that have significant U.S. dollar debts.

All in all, we judge the balance of risks to our projection of global growth to be somewhat tilted to the downside, especially if a combination of increasing political uncertainty, escalating trade tensions, rising interest rates and ever higher debt levels were to trigger a significant loss of confidence and a retrenchment of both consumer spending and business investment.

Section II:
International Trade

Overview

Since our Spring Outlook there have been two very significant positive developments: the conclusion of negotiations on the United States-Mexico-Canada Agreement (USMCA), and the successful ratification of the Comprehensive and Progressive Agreement on Trans-Pacific Partnership (CPTPP) which will come into force on December 30, thereby delivering on Canada's long-time objective of negotiating a free trade agreement with Japan. Despite this progress, uncertainty remains pervasive about the future prospects for global trade cooperation.

Trade relations between the United States and China continue to deteriorate with the Trump administration increasing the number of Chinese products being hit by punitive duties and China responding in kind. In fact, it now appears that Trump and his advisors are more intent on decoupling the Chinese and American economies than in looking for a bilateral accommodation in the trade field. And clearly the trade skirmishes are only part of a larger test of wills between the American hegemon and a rising China.

American trade relations with the European Union (EU) and Japan remain uncertain. U.S. tariffs under Section 232 of the Trade Expansion Act of 1962 remain in place on steel and aluminum and similar duties on automobiles are still threatened. Efforts are underway to try to launch U.S.-EU and U.S.-Japan trade negotiations but no serious engagement has yet occurred. However, continued talk is perhaps delaying the imposition of more duties and that in itself is a positive development.

In North America, NAFTA renegotiations concluded on September 30 with the new USMCA. This deal has weakened some NAFTA provisions but has modernized NAFTA largely by borrowing from the Trans-Pacific Partnership (TPP) from which Trump withdrew at the start of his presidency. Overall, the result is a lessening of uncertainty about the future course of trade relations and supply chains in North America. From Trump's perspective, the worst trade agreement ever negotiated has been replaced by the best. Any lasting alleviation of uncertainty will require the agreement to be ratified notably by the new U.S. Congress, something that is by no means assured.

At the World Trade Organization (WTO) the United States continues to block the appointment of new members (judges) to the Appellate Body, severely hampering the functioning of the dispute settlement system. On the positive side there is a renewed interest in strengthening and modernizing the WTO as evidenced by the informal meeting of 13 WTO trade ministers in Ottawa "to discuss ways to strengthen and modernize the WTO". This meeting did not include China or the United States.

The CPTPP has now been ratified by 7[10] of its 11 signatories and will come into force on December 30 of this year. As of that date a range of American exports notably in the agriculture sector will be discriminated against in the Japanese market in favour of suppliers from CPTPP parties.

The American Political Dynamic and International Trade

The mid-term elections on November 6 have changed the political environment in which U.S. trade policy will be made in the coming months. The biggest change is that the Democrats have taken control of the House of Representatives. This development will result in legislative gridlock. The Democrats will use their new power in the House to conduct investigations into the Trump administration and the president. This will be an obvious distraction affecting the ability of the United States government to conduct business.

On the trade front, it will take a while to determine exactly what the change will mean. Obviously, there will be major changes in the leadership of the various Congressional committees dealing with trade. In the House, the Democrats will take control of the committees but it will be a few weeks before the exact lineup is determined. Richard Neal from Massachusetts, the ranking member, is likely to become the new chair of powerful House Ways and Means Committee. There will also be big changes in the membership of the committee because four sitting Republicans on the committee were defeated and a further eight will retire or resign at the end of the year. Although the Senate remains Republican there will also be changes because the chair of the Senate Finance, Committee Orrin Hatch, is retiring. The first big trade challenge for the new Congress will be consideration of the USMCA.

Trump's vigorous and reckless *America first* approach to trade has certainly caught the attention of U.S. trading partners. Perhaps the most worrying development has been the use and threat of tariffs under Section 232 of the Trade Expansion Act of 1962 which authorizes the president to restrict imports of goods which he deems to be a threat to national security. Under this authority the president has applied duties of 25% and 10% to a range of imports of steel and aluminum products from all countries.[11] An investigation is under way by the Commerce Department to determine if automobile imports are similarly threatening national security and Trump has repeatedly threatened to apply duties of 25% to automobiles and parts from all countries. The notion that these imports are a national security threat is completely bogus. The Trump administration is riding roughshod over the rules in international trade agreements. Cases have been launched in the WTO but the United States is arguing that no outside authority has the right to determine what is necessary to protect national security in the United States. Of course, the duties have raised prices for American manufacturers and the foreign retaliation has hurt American exporters of a range of products. A backlash is developing but so far Trump is weathering the storm without much difficulty. That may change if he actually takes action against automobiles and other products.

Against China the president has used Section 301 of the Trade Act of 1974 which gives the president wide ranging authority to take action against any practice by a foreign government that may be harming U.S. commerce. In particular the administration has used this authority to go after the alleged theft of intellectual property by China and Chinese companies.

The U.S.-China Relationship

As of late October the president, using his authority under Section 301, had put duties of between 10% and 25% on $250 billion of Chinese imports and he further signaled his willingness to make all those duties 25% and to move to penalize the remaining $267 billion of Chinese imports with similar duties.[12]

The relationship between these two dominant powers of the 21st century is deteriorating and not just in the area of trade. In a hard-hitting speech[13] at the Hudson Institute on October 4, Vice President Pence launched a broadside against China. The language is unusually tough and is not designed to lead to any early accommodation with China. The following excerpts give a sense of the tone.

> *"... I come before you today because the American people deserve to know that, as we speak, Beijing is employing a whole-of-government approach, using political, economic, and military tools, as well as propaganda, to advance its influence and benefit its interests in the United States."*

> *"And across the nation, the American people are growing in vigilance, with a newfound appreciation for our administration's actions and the president's leadership to reset America's economic and strategic relationship with China. Americans stand strong behind a president that's putting America first."*

It is hard to see what will change this approach in Washington. The president is now surrounded by more hardline advisors than earlier this year. Gary Cohn has left, replaced as White House economic advisor by Larry Kudlow who does not stand up to the president as Cohn did. The departure of White House Staff Secretary Rob Porter also reduced the voices constraining Trump's anti-trade biases. In this situation, Peter Navarro with extreme views on trade, trade deficits and China has become much more influential. The replacement of Rex Tillerson by Mike Pompeo as Secretary of State has further increased the willingness to take a tough line on China. The influence of Wilbur Ross, who negotiated a deal on steel with China and was subsequently repudiated by Trump, is declining. The role of the Trade Representative Robert Lighthizer, the instigator of the Section 301 investigation against China, is enhanced following his successful renegotiation of NAFTA. And while the majority Democrats in the House of Representatives may question the president's tactics, they share many of his concerns about China.

There is some expectation that Presidents Trump and Xi would meet on the margins of the upcoming November 30–December 1 meeting of the G20 in Buenos Aires and make progress in resolving their differences on trade. Trump has been talking up the idea that some sort of trade deal with China may be in the offing but such a prospect does not seem likely.

Canada has a stake in the outcome because although trade conflict between the United States and China may open up some new opportunities for Canadian commodity exports, it will have negative effects on global growth that will adversely affect Canada by reducing global demand and commodity prices.

It may well be that any eventual resolution of the U.S.-China trade tensions will be found in Geneva through efforts to reform the WTO rather than through bilateral efforts between the United States and China. Both sides may find it easier to engage in a dynamic initiated by others rather than to confront each other directly. There are some modest signs that China may be ready to change some of its practices and accept additional obligations in the WTO. This would be in the context of a collective negotiating effort in the WTO, not as a result of bilateral American pressure. Such a process would take years not months—and could well be preceded by further deterioration in the trade relationship.

Another significant recent development is recorded in a joint statement[14] following a trilateral meeting of the trade ministers of the United States, Japan and the EU in New York on September 25. The statement touches on WTO reform but is basically aimed at China. It addresses concerns with:

- non-market-oriented policies and practices of third countries;
- industrial subsidies and state owned enterprises;
- forced technology transfer policies and practices of third countries; and
- mitigating risks to national security from trade and investment.

U.S.-EU Relationship

Threats by President Trump to impose 25% duties on imports of automobiles and parts from all countries under Section 232 has caught the attention of all significant producers of automobiles, including of course the EU. The EU (with Germany taking an obvious interest) is insisting that the United States remove the Section 232 duties imposed on steel and aluminum and has retaliated against a range of American exports. Efforts have been made to try to lessen the tensions. These efforts culminated in a joint U.S.-EU statement[15] issued in Washington on July 25 after a meeting between President Trump and EU President Juncker. The two sides agreed *inter alia* "to work together toward zero tariffs, zero non-tariff barriers, and zero subsidies on non-auto industrial goods." They also agreed "to join forces to protect American and European companies better from unfair global trade practices. We will therefore work closely together with like-minded partners to reform the WTO and to address unfair trading practices, including intellectual property theft, forced technology transfer, industrial subsidies, distortions created by state owned enterprises, and overcapacity." Obviously this part of the statement was all about China and foreshadowed the September 25 statement also engaging Japan.

Since then there have been ups and downs. EU Trade Commissioner Malmstrom subsequently added that the EU was also prepared to work towards zero duties on automobiles on a reciprocal basis. Then Wilbur Ross complained about the slow pace of progress on a visit to Brussels in mid-October and on October 31 President Trump railed against the EU[16] saying it "has been—I mean, just absolutely hurting the United States" and said that now the United States was negotiating with the EU "from a position of total strength". In the midst of all this on October 16, USTR Lighthizer sent Congress written notification[17] that "the president intends to initiate negotiations on a trade agreement with the EU."

Brexit

A further destabilizing factor in international trade is the uncertainty surrounding the UK's efforts to leave the EU. With intense opposition in Parliament and the Conservative party to the withdrawal agreement concluded with the EU by Prime Minister May, it is unclear on what basis the UK will leave the EU. Furthermore, any withdrawal agreement will leave until later negotiation of an arrangement providing the basis for future trade relations between the UK and the EU. The current agreement provides that the UK will remain in the customs union for the transition period and perhaps beyond which has caused great concern among Brexiters. It seems quite likely that Parliament will reject the withdrawal agreement in December. A wide variety of outcomes are possible. Mrs. May's position as prime minister is under threat, her government could be defeated, a new government might negotiate a different deal, the UK might leave the EU without an agreement. It is even possible although unlikely that a second referendum could be organized.

The United States has engaged in discussions with the UK on the approach to negotiating a free trade agreement (FTA) and Lighthizer has written to Congress notifying that "the president intends to initiate negotiations on a trade agreement with the United Kingdom" ... "as soon as it is ready after it exits from the European Union on March 29, 2019."[18]

U.S.-Japan Relationship

Japan has found itself in a similar position to the EU. Threatening Japan with auto tariffs, Trump has been pressuring Prime Minister Abe to agree to bilateral free trade negotiations while Abe has been suggesting Trump reconsider American membership in the CPTPP. It should be recalled that Japan played the key role in resuscitating the TPP after the American withdrawal. On September 26, Trump and Abe agreed in a joint statement[19] "to enter into negotiations, following the completion of necessary domestic procedures, for a United States-Japan Trade Agreement on goods, as well as on other key areas including services, that can produce early achievements." The statement also speaks to China: "The United States and Japan will also strengthen cooperation to better protect American and Japanese companies and workers from non-market oriented policies and practices by third countries." Japan's agreement is obviously designed to avoid further Section 232 action by the United States. Subsequently on October 16, Lighthizer informed Congress that "the president intends to initiate negotiations[20] on a U.S.-Japan Trade Agreement." Given the different motivations for initiating the negotiations quick progress may be rather difficult.

USMCA: The Overall Situation

Overall, the USMCA will carry forward the rules that have underpinned the North American relationship for the last two decades. However, a lot of damage has been done to the perception in the three countries whose relationship was stable and durable. President Trump has invoked the withdrawal clause to force a renegotiation. Such a development was never seriously anticipated and having been used once what is to stop the United States from using it again?

A rebranded agreement that President Trump has touted as the best trade agreement ever negotiated offers a better basis than NAFTA for managing Canada-U.S. trade relations on his watch. However, one can't help thinking that the North American partners have missed an opportunity to have negotiated something much more significant that would have put the North American partnership on a sounder footing to compete effectively with all comers in a new and more challenging global economic environment.

The agreement that Canadian negotiators, led by Minister Chrystia Freeland, reached on September 30 reduces uncertainty for Canadian businesses. However, at this stage we only have an agreement among the negotiators still subject to legal scrubbing and being translated into Spanish and French. It is expected the USMCA will be signed by the three heads of government at the end of November. That will initiate the ratification process in the three countries. In Canada, the ratification is a foregone conclusion because the Liberals have a parliamentary majority and the opposition Conservatives will clearly vote for the deal although they will no doubt offer some criticism of the government before doing so. In Mexico they view the agreement as a treaty which will need to be approved by the Mexican Senate now in the hands of the party of the incoming President Lopez Obrador. Lopez Obrador has given the agreement his blessing so the Senate will probably support it. The biggest ratification challenge will be in the U.S. Congress. When President Trump formally sends the USMCA and the implementation package to Congress for fast track approval under Trade Promotion Authority, he may decide to increase the pressure on Congress to approve the new agreement by giving the six-month notice that he intends to withdraw from NAFTA. However, this could ratchet up uncertainty and set up a game of high stakes poker. It will be the new Congress that will determine the fate of the USMCA and given all the timing and procedural requirements the final vote in both Houses of Congress is not likely until April or later.

Perhaps the most important development of the last two years for Canadian trade interests in the United States is the fact that Trump's aggressive trade policy has triggered the most thoughtful domestic discussion of U.S. trade interests since the original NAFTA debate in 1992-3. While NAFTA had been a political hot potato for 20 years the public and business had largely tuned out what politicians were saying about trade. Suddenly this changed when the president withdrew from TPP, appeared ready to jettison NAFTA, thwart the WTO, raised tariffs on steel and aluminum provoking foreign retaliation, and threatened to follow suit on automobiles. Alarm bells started ringing as business contemplated increased costs and the closing of markets for American products. Many Americans began to realize that trade was valuable to many businesses, producers, and consumers. Unless Trump changes course, these pressures will continue to build. Late in the game business leaders began to stand up against the administration's trade policy as did politicians of both parties at local, State and Congressional levels. As Michael Froman quipped, Trump had succeeded in making NAFTA popular with Democrats. At meetings to talk about the USMCA, many business representatives are more interested in learning when the steel and aluminum tariffs are coming off. National Foreign Trade Council President Rufus Yerxa is quoted as saying on November 8 that there is "very broad and deep support" for USMCA in the business community.[21]

At the same time the Canadian government has led and conducted across the United States the most active and extensive national advocacy effort ever undertaken. The alliances struck through these efforts will be more valuable to Canadian interests in the long term than the current relationship with the Trump administration. Looking ahead this advocacy work will need to be maintained and even intensified as we enter the period of USMCA ratification.

Trump's trade actions and threats are having a more significant effect on business confidence than any provisions in the USMCA. The actions taken under Section 232 have damaged confidence in the stability and value of the North American partnership. Of course, the whole world is facing the same problem but for Trump to have applied these duties on the basis that Canada poses a risk to the security of the United States is an affront to the history and spirit of the relationship and very damaging to business confidence in Canada. In fact, Trump's use of Section 232 in violation of international trade rules undermines the achievement of concluding the USMCA. One is reminded of the unfortunate adage, "Other than that Mrs. Lincoln, how was the play?" It should be noted that Canada succeeded in negotiating useful side letters with the United States on the use of Section 232 but to some extent these letters also accept the legitimacy of the use of that legislation.

Elimination of the Section 232 tariffs on steel and aluminum remains a top Canadian priority. It is unclear exactly how or when it will be realized but the prospects for successfully achieving this objective before the ratification of the USMCA appear quite good. Certainly various American business interests are complaining about the adverse impacts of both the measures themselves and the retaliation.

USMCA: The Agreement Up Close[22]

Bennett Jones professionals continue to analyze the USMCA. A good initial assessment of the contents can be found in our October 4 blog "Introducing the U.S.-Mexico-Canada Agreement (USMCA)."[23] Another source of information is the "Summary Backgrounder: United States-Mexico-Canada Agreement (USMCA)" which appears on the Global Affairs Canada website.[24]

In this Outlook we will not try to analyze the details of the agreement. Rather we will offer a general perspective on it, consider what it means for Canada and examine a few of the provisions that have been the subject of considerable public commentary.

In our view the USMCA is a mostly positive development at a very difficult time for Canada's trade relations with the United States. The actual provisions of the agreement offer continuity and even some useful modernization elements with provisions imported from the TPP. However, there are also retrograde elements in the text. For instance:

- the wording of the national security exception has been watered down to create a reduced standard of what would be required to invoke it. It is now called "essential security";
- the discipline on government procurement between Canada and the United Sates has been removed from the agreement. As a result it is the WTO Government Procurement Agreement that provides the rules on these matters as between Canada and the United States.[25] While this is a satisfactory outcome it does not augur well for the future use of Buy America that the Americans would not agree to include procurement disciplines in the USMCA; and
- the wording of Article 34.7: Review and Term Extension implies that it is the "head of government" rather than the party to the agreement that would determine whether the agreement should be extended for a further 16-year period. This seems designed to preclude a Congressional role in taking such a decision.

Importantly, however, the USMCA maintains the duty free treatment provided in NAFTA for trade within North America. A new Customs Administration and Trade Facilitation Chapter standardizes and modernizes customs procedures throughout North America to facilitate the free-flow of goods. There are also important improvements to disciplines on technical barriers to trade that will make it easier for Canadian businesses to export goods within the USMCA region. The Rules of Origin chapter contains a number of changes to modernize the rules. These include, for example, an increase of the de minimis threshold from 7% to 10% of FOB adjusted value. In addition the agreement includes chapters on such matters as digital trade, state-owned enterprises, anti-corruption and good regulatory practices, largely borrowed from the TPP.

One provision that has received a lot of attention is Article 32:10: Non-Market Country FTA. This provision requires consultation in the event that a party to USMCA initiates negotiations with a country which at least one USMCA party has determined to be a non-market economy. The article further provides that "Entry by any Party into a free trade agreement with a non-market country, shall allow the other Parties to terminate this Agreement on six-month notice and replace this Agreement with an agreement as between them (bilateral agreement)." The obvious "non-market country" in question is China. A number of observers have suggested this is a clear intrusion into Canadian sovereignty. Although we find the article gratuitous that is not our take. The article does take a shot across our bows but it changes little in substance. The United States already had the right to withdraw from NAFTA on six months notice for any reason and that provision remains in a separate USMCA provision. What is most disappointing is that the United States has chosen to threaten two of its closest partners about their potential dealings with China rather than work with them in a cooperative fashion to help to integrate China more effectively into the global trading system.

The second provision we will take up here is Article 34.7: Review and Term Extension, the origins of which came from the American sunset proposal that the new agreement should terminate after five years unless the three governments agreed to extend it. The article provides for a joint review within six years by the Free Trade Commission[26] which would review the operation of the Agreement and any recommendations for action submitted by a Party, and decide on any appropriate actions. Obviously this could lead to proposals to amend the Agreement. As part of the review "each Party shall confirm, in writing, through its head of government, if it wishes to extend the term of the Agreement for another 16-year period". If there is such agreement the USMCA would be extended for a further 16-year period with another review after no more than six years. If there is not agreement, the Commission would meet annually every year for the duration of the Agreement. At any point during this period the parties could agree to extend the agreement for a further 16 years by confirming in writing their intention to do so, through their respective head of government. Failing such action the Agreement would terminate after 16 years.

Article 34:7 provides a mechanism for the parties to update the Agreement in the light of changing circumstances. It provides a deliberative approach which seems preferable to simply relying on the six-month withdrawal clause to force a renegotiation. The 10-year period after an inconclusive review also leaves ample time to find a way to allow the Agreement to continue for a further 16 years.

Several provisions have been included in the USMCA to provide precedent for their inclusion in other trade agreements yet to be negotiated. That is certainly what motivated the Americans to propose a provision on macroeconomic policies and exchange rate matters that has now become Chapter 33 in the USMCA. The chapter sets a precedent for including such matters in a trade agreement; however, the undertakings in the chapter, including that "Parties refrain from competitive devaluation, including through intervention in the foreign exchange market" are consistent with long-established Canadian policy and are situated within the framework of the Articles of Agreement of the International Monetary Fund to which all three countries are already party. The chapter also creates engagement mechanisms, including a trilateral Macroeconomic Committee and a process of bilateral Senior Representative Consultations, as needed, that are consultative and not binding in nature. The chapter is unlikely to be negative for Canada and may be marginally positive for all parties.

Importantly Canada and Mexico succeeded in eliminating or taming the most egregious American proposals as follows:

The proposed weakening of the dispute settlement provisions met with strong resistance and the final deal provides for the continuance unchanged of the intergovernmental dispute provisions of NAFTA Chapter 20 and the special binational panels for review of anti-dumping and countervailing duties in Chapter 19:

- the sunset proposal was successfully modified as described above;
- the proposal requiring 50% U.S. content in the automobile sector was dropped; and
- proposals to eliminate Canada's supply management system were successfully resisted.

Our final conclusion is that, while not as good as it might have been, the new USMCA is much better than what many Canadians expected in the middle of the negotiations. It is also much better than no NAFTA. There is no prospect of being able to improve the deal at this stage, so Canada should be pulling out all the stops to get if ratified.

WTO

The challenges facing the multilateral trading system continue unabated. The WTO, the center of the rules-based trading system, has been unable to check rising tensions between major trading partners and its Director-General recently conceded that the global trading system is "facing a crisis".[27] Nevertheless, we no longer hear of the impending demise of the WTO or fears of a United States departure from the organization. In fact, the United States continues to contribute to the regular work of the WTO and is actively participating in new WTO initiatives, including exploratory work towards negotiations on digital trade. Moreover, WTO Members continue to turn regularly to the WTO dispute settlement mechanism for resolution of their trade disputes. Finally, efforts to improve and modernize the WTO have intensified in the last few months, with Canada playing a leadership role in that effort.

Despite increasing concern about the WTO dispute settlement mechanism soon grinding to a halt due to the United States' continued objection to launching a process to fill four empty seats on the seven-member Appellate Body and the increasing challenge for first instance panels to keep up with demand, WTO Members continue to demonstrate support for and faith in the WTO dispute settlement mechanism. Thirty-five new disputes have been filed so far in 2018, the highest number since 2002.[28] Eight of those were filed by the United States (six relate to measures taken in reaction to the U.S. steel and aluminum tariffs) and five by China (all against the United States). The United States is the respondent in 18 of the 35 new disputes, nine of which concern the U.S. imposition of tariffs on steel and aluminum products. China has been challenged four times (twice by the United States, once by Brazil, and once by the European Union). Canada for its part filed a challenge against the United States' imposition of steel and aluminum tariffs and the United States, in turn, challenged Canada's retaliatory tariffs.[29] Other WTO Members who filed complaints this year cover a broad spectrum of political and economic influence and include Australia, India, Norway, Qatar, Russia, Tunisia, United Arab Emirates, and Vietnam.

This show of faith in the system for resolving disputes is unlikely to last, however. This is because the Appellate Body is down to three members (judges)[30], the minimum needed to decide an appeal. There are currently 12 appeals in the system and this number will only continue to rise as panel reports are issued. The rate of appeal has always been high (averaging approximately 70% overall since 1995), but losing parties are almost certain to file appeals to ensure that their impugned measures stay in place during the inevitable delay in obtaining a final result on appeal. One year from now, two more Appellate Body members will finish their second and final terms, leaving only one Appellate Body member (from China) on the bench. At that point, the Appellate Body will no longer function because the requisite three members per appeal cannot be met.

The impending "crisis" in the dispute settlement function of the WTO has spurred some WTO Members to launch efforts to "save" the WTO. Although discussions on improving the dispute settlement system have been underway for several years and numerous proposals were tabled, analyzed and discussed at length, not a single amendment was adopted, due mostly to Members' inability or unwillingness to agree on any package that did not include their favourite initiative. However, recent reform efforts have taken on an air of urgency and seem to be of a different order. For one thing, they reach well beyond technical amendments to dispute settlement rules and go to the very essence of the dispute settlement function of preserving the rights and obligations of Members under the WTO agreements. In addition, reform ideas address underlying issues related to improving the effectiveness of the WTO as a rule-making institution (e.g., unblocking the consensus-based negotiating function by pursuing plurilateral negotiations that could lead eventually to MFN application), as well as the need to update WTO disciplines to cover new areas (such as digital trade). Importantly, they also include proposals addressing issues the United States has been especially vocal about recently, including improving subsidy disciplines to better capture support provided by state-owned enterprises, rules on forced technology transfer, and a new approach for accommodating different levels of development, which refers to the debate over economies like China and India receiving the same flexibilities in taking on trade commitments as afforded to much less developed economies.[31] A second difference in the current reform push is that discussions have graduated from technical dialogue among legal representatives to high-level meetings of Ministers who seem determined to move forward urgently. Trade Ministers from the United States, Japan and the European Union first joined forces at the WTO Ministerial meeting last December and have since met in May and September to discuss a variety of initiatives, including strengthening WTO rules and increasing effectiveness of WTO committees.[32] And on October 24 and 25 of this year, Canadian International Trade Diversification Minister Jim Carr hosted a meeting in Ottawa of 13 trade ministers[33] to discuss strengthening and modernizing the WTO. The 13 trade ministers resolved to address concerns about the functioning of the dispute settlement system, reinvigorate the negotiating function of the WTO, and update WTO rules to reflect 21st century realities.[34] The ministers will meet again on the margins of the Davos meeting in January 2019 to review progress made by officials tasked with pursuing discussions.

These initiatives are encouraging. A proper functioning dispute settlement system is critical for Canada, which has regularly used the system to challenge measures that affect Canadian trading interests, including lumber, beef and auto parts.[35] It is also vitally important to WTO Members more broadly, for it is the only available means to ensure compliance with multilateral trade rules. Improvements to the negotiating model are also necessary, as is modernizing the rule book itself. Realistically, however, these efforts are unlikely to produce results quickly and any specific set of changes would be expected to meet strong resistance from some WTO Members.

We believe that Canadian business should support Minister Carr's multilateral initiative to reform the WTO and urge him to work first and foremost to safeguard and strengthen the WTO dispute settlement system. Despite (or perhaps because of) the obstacles posed by the coming clash between the United States and China in the technology space, a small open economy like ours relies on an agreed dispute settlement mechanism. Minister Carr should also be encouraged to consult with additional WTO Members with a view to obtaining broad-based support for the results.

CPTPP

Canada's efforts at trade diversification will receive a significant boost on December 30 when the CPTPP comes into force following ratification by six of its signatories.[36] Canada ratified the Agreement on October 29, becoming the fifth country to do so. Ratification by the remaining four signatories is expected by the end of the first quarter of 2019.

The first tariff cuts under the agreement will be on December 30, the date of implementation, and the second cuts will be on January 1, 2019, providing Canada a quick edge over non-party competitors such as the United States.

Once the agreement comes into force, the parties will need to address in earnest the interest of a number of countries in acceding to the agreement. Likely potential candidates include Thailand, Indonesia, Colombia, the Republic of Korea, and Taiwan (China), all of which have expressed interest in joining. In the event of a hard Brexit, the UK could try to push its way to the head of the line.

Conclusion

The changes in the global geo-economic trade context over the last decade have been dramatic. The United States under the Trump administration has reversed 70 years in which the United States was both the principal architect and guarantor of an open, liberal, rules-based international trading system. This has adversely affected many countries but has and will have a significant negative impact on Canada. Canadians can no longer assume that they can count on the U.S. market as an extension of their own. China with a different economic model is emerging as perhaps the dominant power of the 21st century. At the same time, the credibility of the WTO has been eroded largely because its negotiating function has floundered, and its dispute resolution system is now under threat. This weakness is one reason why there has been a surge in the development of overlapping regional agreements, particularly around the Pacific. Some of these involve China and others do not. By and large the agreements providing deeper integration do not.

The challenge of dealing with this new trade context is made greater by the rapid emergence of new technologies which will revolutionize traditional methods of production and delivery to markets of goods and services.

What should Canada do in this changed environment? Is it sufficient to continue to look to develop better trade arrangements with all or do we need to start analyzing strategic choices? Is closer integration with China compatible with considering what we need to do to protect our interests in the U.S. market? What role, if any, can Canada play in conjunction with others in promoting possible rapprochement between China and the United States? These questions need to be addressed in the context of the overall strategy for the economic growth in the decades ahead. We return to these questions in Section IV.

Section III:
Canadian Outlook

Recent Developments

Canadian growth rebounded to 2.9% in 2018-Q2 from 1.4% in 2018-Q1 on a surge of exports and solid advance in household consumption. Housing resumed growth but modestly after large fluctuations in 2017-Q4 and in 2018-Q1 related to revised mortgage underwriting guidelines that became effective in January.[37] While non-residential business investment increased only slightly in 2018-Q2 following several quarters of strong growth, the autumn Business Outlook Survey of the Bank of Canada suggests a substantial pick-up in firms' investment intentions for the next year relative to the spring and summer surveys.

Core CPI inflation has shown no sign of acceleration this year, being stable at about 2% up to September, consistent with an economy at or very close to capacity and inflation expectations solidly anchored at 2%. Various indicators of average wage rate have shown only modest yearly growth and no sign of persistent upward trend this year. The Bank of Canada raised its policy interest rate in July and October by 25 basis points each time to bring it to 1.75%. On a monthly basis, the Canadian dollar has been relatively near around 77 U.S. cents since last April.

Prospects to 2021

As in the rest of the world, growth in Canada is projected to slow to its potential rate of around 1.7% by early 2021. On an annual basis, real GDP growth in Canada should decelerate from 2.1% in 2018 to 2.0% in 2019, 1.8% in 2020 and 1.7% in 2021, much as in our Spring Outlook. Trend productivity growth for the whole economy is assumed to be 1.2% throughout, matching actual average productivity growth over 2011-17.

A significant part of the slowdown in growth arises from gradually smaller contributions from **household consumption** in response to higher interest rates and slower growth in employment and real income. Higher interest rates would raise the interest costs to be paid by households on new borrowing, on variable-rate household debt, and on the part of the large fixed-rate mortgage and consumer debt that becomes due for renewal, thereby reducing both the incentive and the room for increases in discretionary spending. **Housing** should be relatively flat over the projection horizon, with the positive impact of an increasing demographic demand balanced by the negative impacts of higher mortgage rates and the changes to mortgage guidelines.[38] Notwithstanding competitiveness challenges, transportation constraints in the energy sector and new U.S. tariffs on steel and aluminum products from Canada, **export volumes** are projected to grow at a moderate pace in the short term, sustained by healthy growth in U.S. activity and an expected alleviation of domestic capacity constraints in the non-energy sector through investment.

The pace of **business fixed investment** is expected to be generally slower after a solid advance in 2018 when firms have been seeking to alleviate capacity constraints, accommodate anticipated strength in demand, and/or improve efficiency in the face of competitiveness challenges. Factors restraining investment intentions going forward are: gradually slowing growth in domestic and foreign aggregate demand, continued productivity and competitiveness challenges, and the somewhat less favourable North American trade arrangements going forward. On the other hand, the dissipation of some of the uncertainty related to NAFTA renegotiations opens the door to implementing delayed investment plans.[39] Moreover, the large-scale LNG Canada project should boost capital spending significantly down the road.

The substantial widening of the **WCS oil price discount to the WTI price** between May and October in principle reduces Canada's terms of trade and corporate profits and could depress aggregate demand. One issue from a macro perspective is to what proportion of total oil production does the discount apply, given that not all producers get the same price. Statistics Canada reported that current-dollar crude oil exports increased for a seventh month in a row in September and that increases in oil export prices contributed to these gains. This suggests that up to that point the effect of the widening of the discount on Canadian oil was more than offset by other factors. In all likelihood, this has changed for the worse since then, given that the discount has climbed to record levels while the WTI price fell by nearly US$20 between early October and mid-November. Confronted with low prices and shortages of storage and transportation capacity for oil, several producers have recently announced production cutbacks. These low prices will have an impact on Alberta government revenues and on drilling activity, slowing growth in Alberta in 2019 at least. We do not expect such adjustment to have a material effect on overall Canadian growth but, if sustained, it will pose a growing downside risk to the Canadian outlook. It is worth noting that crude bitumen and total oil production in Alberta reached record high levels in August, according to Statistics Canada.

In our Spring Outlook we estimated that the 2018-2019 **government budgets** tabled early in the year would stimulate Canadian growth significantly in 2018 and 2019 but have no effect on it afterwards. The present outlook comes too early to offer an analysis of the implications of the fall fiscal updates of the Government of Canada and the new Government of Québec for the profile of the aggregate fiscal impulse to growth in the short term. The new Ontario government's *2018 Economic Outlook and Fiscal Review* shows a sizeable revision to Ontario's deficit for FY 2018-19 to $14.5 billion from $6.7-billion forecast in Budget 2018, as a result of changes to accounting recommended by the Independent Financial Commission of Inquiry and various tax and expenditure announcements since the election. The Review gave no indication of what measures the government might take in 2019 to restore fiscal balance.

In the absence of definitive new fiscal plans from the federal government or the provinces, in this Outlook we have incorporated the same impact of fiscal policy for the next two years that we estimated in our Spring Outlook. Nevertheless, we know that fiscal plans for the next two years are likely to change to reflect changed priorities (especially for new governments in Québec and Ontario). Also, going forward governments will be confronted with somewhat lower revenue growth, reflecting slowing nominal GDP growth, and rising debt service charges due to interest rate increases. These expected developments will restrain the room for manoeuver with respect to program spending. In January, we plan to issue a pre-budget analysis of federal and provincial revenue and expenditure planning issues.

The Bank of Canada has recently indicated that the Canadian economy is operating at capacity and its policy interest rate will need to rise to a neutral stance to ensure that CPI inflation continues to be about 2% in the face of slightly faster-than-potential growth rate in the near term and a likely pick-up in wage growth. With inflation expectations still firmly anchored at about 2%, we expect as before that the pace of increase in the policy rate will be measured, reaching 2.5% to 3% by the end of 2019, with no further increase afterwards. Based on our assumptions concerning oil prices, growth and policy interest rates in the United States and Canada, we judge that the Canadian dollar will continue to move in a band centered on slightly less than 77 U.S. cents.

Risks to the Canadian Outlook

The risks to our global outlook that were identified at the end of Section I represent risks to our Canadian outlook as well, given the strong trade and financial ties between the Canadian economy and the rest of the world. In particular, escalating trade restrictions by the United States and China have materialized and could intensify further with potentially grave consequences for global growth, trade and commodity prices. They create negative risks to currently projected Canadian growth in 2019 and 2020.

Our Canadian outlook is also at risk due to factors that apply more particularly to Canada. Thus, as noted in the trade section, while the agreement on a new USMCA is an inferior arrangement to the current NAFTA for Canada, it nevertheless significantly reduces uncertainty about North American trade arrangements and, once it is confirmed, may contribute to a little more growth in Canadian investment and GDP than projected.

Volatile oil and commodity prices, as always, constitute both upside and downside risks to our Canadian projection. The price discount on Canadian heavy oil will also be volatile but it most likely will remain historically large until at least mid-2019, and through this period it represents a small negative risk to Canadian aggregate growth. On the other hand, stronger-than-expected Chinese growth could buttress higher prices for commodities with a small upside risk to Canadian growth as a result.

Finally, as mentioned earlier, the 2019-20 fiscal plans of the federal and provincial governments may differ significantly from those presented last spring. On balance, risks are tilted to the downside.

Section IV:
Challenges for the 2020s

In the previous chapters, we discussed the outlook for economic growth and trade over the next couple of years. In this chapter, we shift our focus to the medium term, the decade to 2030. Our purpose is to outline briefly, some key trends which will shape the demographic, technological, trade and climate change challenges which Canadian businesses and governments will have to deal with in the decade ahead. Our objective is not to provide specific forecasts of future developments. Rather it is to paint a broad-brush landscape of some of the issues that must be considered in shaping a strategy to deal with the challenges and opportunities in the decade ahead.

The Demographic Challenge

As the baby boom generation leaves the Canadian labour force during the next decade, the aggregate labour force participation rate will continue to fall. Based on current trends, total hours worked will likely increase by only 0.58% per annum over the next decade (Table 2).[40] This compares to 1.7% per annum in the decade prior to 2008 (before baby boomers started to retire) and to 1.16% over the 2011 to 2017 period. The implication of this demographic shift alone (the aging effect in line 3 of Table 2) is that potential growth of Canadian GDP due to growing labour input would be a full 1.1 percentage points less than it was at the beginning of this century were it not for other changes in labour input. Even more worrying, trend labour productivity for the total economy slowed from 1.46% per annum in the decade to 2008 to only 1.15% in the most recent period, the same rate as prevailed from 1983 to 1997. Were this trend to continue in the twenties, real GDP growth would slow from 2.3% to 1.73%. Real GDP growth per capita, which declined from 2.2% in the decade prior to 2008 to 1.01% over the last six years, is projected to decline further to only 0.73% per year in the 2020s.

Table 2

	1998-2007	2011-2017	2018-2028	1998	2007	2011	2017	2028
	% Growth			Levels				
Population 15+	1.32	1.23	1.00					
Labour force participation rate	0.38	-0.24	-0.27	65.1	67.4	66.7	65.8	63.9
Aging effect	-0.24	-0.50	-0.40					
Cohort effect	0.62	0.26	0.13					
Employment/labour force	0.33	0.26	-0.09	90.9	94.0	92.5	93.7	92.8
Hours per job	-0.25	-0.07	-0.07	1,785	1,741	1,700	1,695	1683
Total hours worked	1.70	1.16	0.58					
Labour productivity	1.46	1.15	1.15					
Real GDP	3.20	2.32	1.73					
Real GDP per capita	2.20	1.01	0.73	41714	52265	52162	54781	59835
Investment/GDP (Current $))	-0.48	-0.26	0	11.2	10.3	10.3	9.5	9.5
M&E and IP investment/GDP	-1.09	-1.95	0	8.9	7.3	6.2	5.4	5.4
Population 70+/population 20-69	1.0	2.3	3.5	13.2	14.3	14.8	17.1	25.0
Population 75+/total population	2.1	1.5	3.1	5.3	6.3	6.6	7.2	10.1
Sources: Statistics Canada, various tables, and authors' calculations.								

Normally, this dramatic slowing of per capita output growth would imply a comparable slowing of growth of real per capita incomes and consumption of workers barring significant changes in the terms of trade and in personal taxes and transfers. But, as the fraction of the population over 75 years of age almost doubles from 6.6% in 2011 to an estimated 11.1% in 2031 (and then further to 14% in 2041), the share of national income that will need to be devoted to support the elderly (health care, pensions, social service, etc.) rises. This will leave little or no room for increase for the working population or for the education and support of children.

In summary, the age structure of the Canadian population throughout the coming decade suggests that there may be almost no improvement in the real level of consumption enjoyed by Canadians of working age unless they either work more hours or add more valued output in each hour they work. Before turning to the challenge of raising productivity and investment in the 2020s, we consider the scope for increasing the growth of output by increasing total labour hours supplied.

After rising steadily during the last quarter of the 20th century, labour force participation of "prime age" workers has remained more or less stable since the beginning of the 21st century at roughly 86% for men and 82% for women. The participation rate for older workers is much lower (43% and 32% in 2017). For males, it fell for many years before rising somewhat from the turn of the century onwards, while for females it has risen noticeably more since the turn of the century.

While the scope to increase effective participation rates for prime age males is very low and that for prime age females is limited,[41] there is scope to raise participation rates of the "young old", males and females in the 55 to 74 age range. If the participation rate of this group by 2028 were to be raised from the current levels by about four percentage points in the case of males and seven percentage points in the case of females, this, along with a one-point gain in the prime-age female participation rate, would offset two-thirds of the negative impact of population aging on the aggregate labour force participation rate and raise the rate of increase of total hours worked from 0.58% pa to 0.72%. This shift would raise potential growth of GDP per capita in the 2020s from a projected 0.73% pa back to 0.88% assuming no change in the rate of growth of productivity.

Our analysis indicates that raising the participation rate of the "young old" is quite feasible. The participation rate of this cohort has already been increasing in recent years. Further increase should be possible given the improved health of this cohort, the higher level of education of this cohort and the increasing demand for workers in the service sector (especially the care sector) where the physical requirement of work is less of a limiting factor on participation. Employers facing skill shortages and increased pension costs already have an incentive to hire "young old". Governments can appropriately increase the incentive to participate by increasing the qualifying age for OAS/GIS payments and provincial benefits programs (e.g., drugs) for the elderly. This incentive for increased labour force participation of this age cohort, in our view, would constitute an efficient reallocation of public resources and an appropriate way for the baby boom generation as a whole to reduce their demand for income transfers from younger cohorts. Unfortunately, changes in the qualifying ages for OAS/GIS benefits in the 2020s introduced by the current government have moved the incentive to participate in precisely the wrong direction.

We thus conclude that raising labour force participation can increase the contribution of labour to Canadian potential GDP growth in the 2020s from about 0.58% per annum to perhaps as much as 0.72%. But, without significant improvement in productivity from current trend growth of 1.15%, real growth in GDP per capita will be limited to 0.88%.

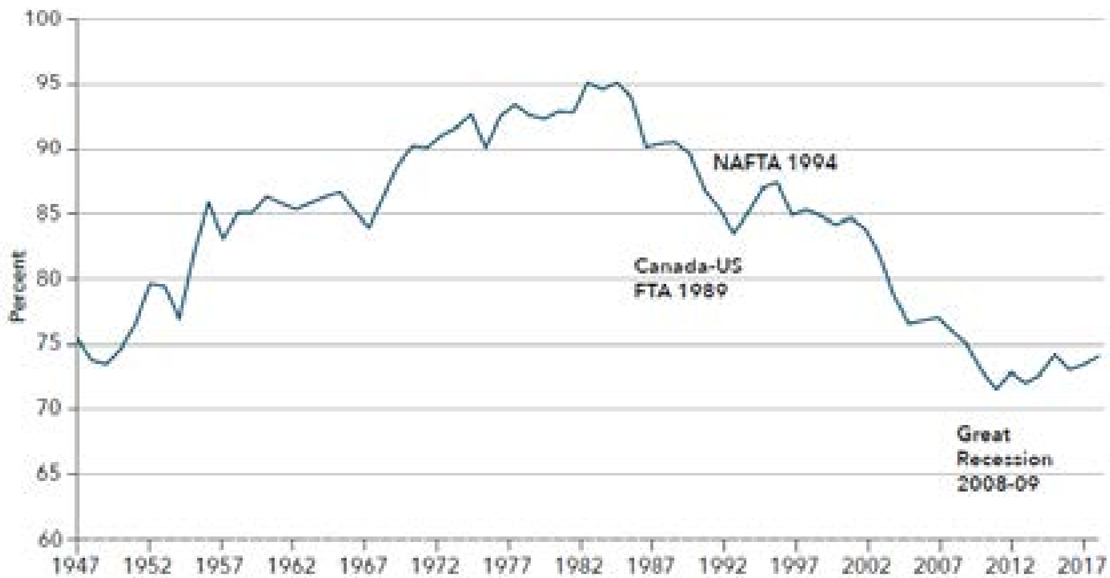
The Productivity Challenge

Because of the change in the age structure of our population over the next decade, Canada can no longer rely on increases in the employment/population ratio to maintain income growth in absolute terms and relative to the United States. To maintain growth, and in particular to maintain growth relative to the United States, productivity must increase not only relative to our recent past performance but also relative to that of the United States. This will require that Canada reverse the long downward trend in our relative performance to the United States, as shown in Chart 1, at a time when American businesses are making massive investments in AI and advanced technologies.[42]

Productivity improvement starts with investment in research and development of new processes and equipment, investment which has been seriously underfunded in Canada. The lack of Canadian investment in R&D and intellectual property is not a new phenomenon, but it has become increasingly serious since the end of the 1990s, as can been seen from Chart 2.[43] Indeed, in the 10 years from 2006 to 2015, R&D spending in Canada hardly grew (0.1% per year) while on average across the OECD spending grew at 2.5%. By 2015, business direct spending on R&D amounted to only 0.9% of GDP in Canada compared to 1.99% in the United States and to 1.64% in the OECD areas as a whole.[44] While there is no guarantee that spending on R&D will translate into increased labour productivity, technological advance begins with this investment, which is then embodied in improved amount and quality of machinery and equipment per worker through capital investment by industry.

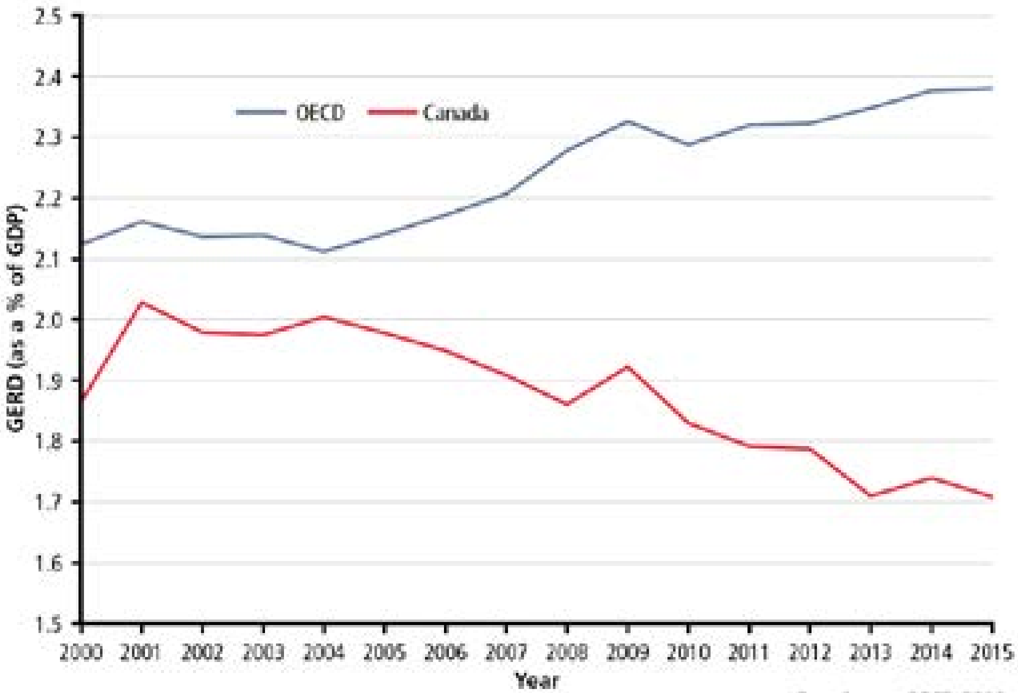
Since new technology, resulting from R&D, is embodied in capital investment in machinery and equipment, the key to enhancing the productivity of Canada's labour force is increased investment by business in machinery and equipment. But, on this front, Canadian business has been increasingly deficient this century. Investment in M&E has actually plummeted from 7% of Canadian GDP in 1998 to around 4% in the period since 2011. Similarly, investment in intellectual property products has dropped from a peak of 2.3% of GDP at the turn of the century to close to 1.7% in 2016-17. Canadian investment in software and databases, the key component driving much of advances in AI and productivity enhancing production processes, is seriously deficient relative to the United States and many other OECD countries. For example, investment in ICT per worker has been only about half the level observed in the United States since 2011.

Chart 1: Labour Productivity, Canada as a percentage of United States, 1947-2017



Source: Centre for the Study of Living Standards, "Income and Productivity Data," Ottawa, http://www.csls.ca/data.asp

Chart 2: Gross Expenditure on R&D



Data Source: OECD, 2016a

This lack of investment in machinery, equipment and intellectual property products since 2011 is particularly disturbing in light of the relatively high level of profits in the Canadian economy since 2011. By 2017 corporate profits had almost doubled to 15.2% of GDP compared to only 8.4% in 1997 while at the same time the share of GDP devoted to investment in M&E fell by almost half.

The challenge facing governments is to put in place policies, which increase the incentive for business to make these productivity-enhancing investments. In our Spring Outlook, we discussed key supply-side policies where governments could act to remove obstacles to investment and improve incentives to encourage investment:

- predictable, stable and efficient regulation;
- tax measures focused on new investment only;
- education and immigration policies;
- investment in complementary productive public infrastructure; and
- preservation of a strong fiscal position.

While governments have the responsibility to do these things, ultimately it is the responsibility of businesses to invest, innovate and grow their businesses. In the end, it is pressure from competition from other businesses that provides the ultimate incentive for any enterprise to make the investments which in the end will generate aggregate productivity growth and rising national income. It is competitive pressure (the fear of failure and lure of future profit) that drives change and innovation. Hence, it is the demand side policies of government, not just the traditional supply-side policies listed above, that are equally important in promoting innovation and productivity growth. Policy in the form of providing (and enforcing) a level playing field at home and access to foreign markets is essential. At home, this involves effective traditional competition policy and IP protection. The removal of anti-competitive barriers to competition across geographic and jurisdictional boundaries—however politically difficult—is very important. And, perhaps as important as these domestic policies aimed at creating domestic competition will be in the 2020s, our future trade policies will be equally important in promoting innovation and domestic competition. It is to the trade challenge we now turn in the next section.

The Trade Challenge

Canadians face growing trade challenges over the coming decade that will require the country to take important strategic decisions that will have a significant impact on Canada's place in the world. In Section II, we outlined the background for this challenge and explored some of the immediate actions required by the government to manage its various bilateral and regional relationships. But, it also needs to work on a longer term strategy to ensure that the international trade rules respond to the geostrategic challenge of managing a deteriorating global trade environment led by the confrontation between China and the United States. We believe the challenge will increase over time. Canada needs to decide now on its basic approach.

The immediate trade challenge and the one that must dominate the short term is managing Canada's North American relationships (particularly with the United States) in a way that is forward looking, creates secure access to North American markets, and most importantly increases competitive pressure to innovate. We cannot escape the fact that some 75% of our exports go to the United States and that our economy is deeply integrated into the North American market place. The last two years have shaken business confidence in the stability of the Canada-U.S. economic relationship. Canada needs to work to restore that confidence by addressing three major elements. First, Canada must secure ratification of the USMCA to ensure a continuing strong framework for the conduct of our bilateral trade. Second, Canada must effectively manage ongoing trade disputes, including protectionist threats from the Trump administration. This will involve working to remove tariffs on steel and aluminum and the related retaliatory measures put in place by Canada. It will also mean being ready to firmly resist any new such measures. Third, to rebuild confidence that business can consider the American market to be truly open to Canadian business the government should look for ways to strengthen further the bilateral relationship. And, it must involve being prepared to consider what corresponding domestic reforms might be needed to support that objective and which at the same time would support efforts to spur innovation, raise domestic productivity and thus to make the Canadian economy more competitive. This must involve reducing the barriers to foreign competition in over-protected sectors of our domestic market. Canada should continue broad-based advocacy efforts, which recognize the diffuse nature of power in the United States and the importance of support across the nation. We should also work with Mexico when that serves our interests, as it often will.

The second trade challenge, which may play out over a somewhat longer time frame, is diversification of Canada's international trade. This will mainly involve successfully implementing and negotiating free trade agreements and strengthening multilateral cooperation through the WTO. On the free trade front, the focus should be on agreements that can make a real economic difference to Canada. Here we would specifically include CPTPP, CETA, a CETA plus agreement with the UK (Canada's most important country market in the EU), and negotiations with ASEAN. Of course, we also need to work with our second largest partner, China, but that will be addressed more fully below. Other agreements should still be pursued but they should not take resources away from Canada's principal trade tasks.

The WTO is an essential agreement for managing Canada's trade, even with the United States. The government should continue the efforts initiated by Trade Diversification Minister Carr to work with others to revitalize and modernize the WTO. Part of that will be identifying what issues, both new and old, need to be given priority in a 21st century WTO, issues that are important for increasing market access and competition in sectors undergoing rapid technological change. Additionally, it should involve devising ways in which the WTO can better serve as a platform for managing the trade relationship between the United States and China. Indeed, this might turn out to be the most important part of Canada's efforts to strengthen the WTO.

The third trade challenge is how Canada conducts trade policy in an environment where are our two largest trade partners are engaged in a strategic battle about how economies should be organized and what international trade rules are appropriate. Of course, the geostrategic competition between China and the United States, the world's two dominant trade powers, goes well beyond trade. This competition is not just that which would be expected between the hegemon and the rising new super power. It also stems from the fact that China and the United States have very different models of how an economy should be organized, models which in important ways are not readily compatible. For Canada, finding its way in this environment is the biggest and most difficult trade challenge for the coming decade. Ten years from now the Chinese economy will be far larger than the American and the Chinese will have a much larger share of world trade, including in advanced technology products. The Americans have already made it clear they are concerned about China playing a key role in the development of the next generation of information technology products including especially the development of 5G broadband networks. We have already seen signs that at least the current U.S. administration is concerned about the development of Canada-China trade relations and the prospect of Canada negotiating an FTA with China. There are persistent reports that the United States and China may resolve their trade differences prior to the November 30 to December 1 G20 summit in Buenos Aires. Any announcement that might be made will not address the fundamental difference between the two countries.

Ten years hence, the gross volume of Canada's trade with the United States will still be more important than Canadian trade with China but Canadian trade with China will be growing more rapidly. The government should work to put the bilateral trade relationship with China on a firmer footing. An FTA would do that. However, further deterioration in the China-U.S. relationship might make it very difficult for Canada to have FTAs with both super powers. At the same time, Canadians will not want to be disadvantaged in the Chinese market by competitor countries which have negotiated FTAs with China. The government needs to make a clear-eyed assessment of the situation, taking into account a range of factors, one of which should be consideration of which market might offer the best value-added opportunities for Canadians. In its analysis, the government should carefully consider whether a revitalized WTO might offer a way through this environment fraught with risk. A dynamic discussion on the future of multilateral trade triggered by middle powers might offer a platform on which the United States and China could engage in an effort to broker their trade differences. Certainly, promoting any process, which stands a real chance of helping to reduce tensions between the United States and China, would be a good investment for Canada.

The last decade has provided many trade challenges for Canada. Managing the coming decade may be a lot more difficult.

The Climate Change Challenge

In confronting already difficult demographic, technological, and trade developments for the medium to long term, Canada must situate its policies within the frame of trends affecting the global climate and energy system. Climate change is a global problem that illustrates both the necessity and the limitations of national (and provincial and local) actions and global cooperation. The challenge of mitigating climate change and adapting to its consequences is compounded internationally by the desired pursuit of the United Nations Sustainable Development Goals and necessary efforts to deliver energy sustainably to a growing global population, including close to 1 billion individuals who still do not have access to electricity. While the Paris Climate Change Conference of 2015 was hailed by many as a triumph of French and global diplomacy, with 195 Parties to the UN Framework Convention on Climate Change (UNFCC) pledging to curb emissions of greenhouse gases (GHGs), in fact policy developments since then have not broken the back of underlying trends of rising global energy demand and emissions.

Participants at the Paris Conference agreed to take action to hold global temperature rise to well below 2 degrees Celsius and indeed to pursue efforts to limit the increase to 1.5 degrees. The Intergovernmental Panel on Climate Change (IPCC) observed in its latest report that to stay within the target of 2 degrees, global GHG emissions need to decline by about 25% from 2010 levels by 2030 and reach net zero around 2070.[45] To limit the temperature increase to 1.5 degrees, emissions would have to drop by 45% and reach net zero by 2050. The co-chair of one of the IPCC working groups offered that "limiting warming to 1.5 degrees is possible within the laws of chemistry and physics but doing so would require unprecedented changes".[46] Indeed, even limiting warming to 2 degrees is very ambitious against forces that are otherwise pushing emissions upward.

The International Energy Agency (IEA) just published its World Energy Outlook 2018. The IEA identifies a range of ongoing structural transformations in the energy system, including a rising share of electricity in global energy demand and rapid growth in the deployment of solar and wind power. Nonetheless, demographic and economic growth in Asia dwarf the effects of other factors around the globe. Under what the IEA calls its "New Policies Scenario", which includes announced policies and targets, energy demand grows by more than a quarter to 2040, despite roughly equivalent improvements in energy efficiency. In this scenario, demand for coal as a primary energy source only stabilizes. The demand for oil is projected to peak only in 2040, by which time it is about 106 million barrels per day (mb/d), 11 mb/d more than today (with the United States capturing 75% of the growing volume until about 2025). The demand for natural gas rises in both advanced and developing economies, with robust growth in LNG trade. Overall, the IEA projects that under this scenario, emissions from the energy system remain on a (slow) upward trajectory to 2040, "far out of step with what scientific knowledge says will be required to tackle climate change". As emissions in the energy system—the combustion of fossil fuels—represent by far the larger share of global emissions of GHGs, it is evident that the global community has not yet come close to resolving the problem of climate change.

Canada represents less than 2% of global emissions of GHGs and cannot solve this equation. Indeed, it also faces challenges toward meeting its official target of cutting domestic emissions by 30% from 2005 levels by 2030. In its last official report to the UNFCC, the Government of Canada estimated that with both existing and additional policies and measures under development but not yet fully implemented (as of December 2017), its emissions in 2030, absent other measures, would still be about 13% above the target.[47]

In the circumstances, in addition to adaptation to a changing climate, Canada must find the way to make the best and smartest possible contribution to global efforts to bend some of the curves while also realizing opportunities in an evolving global energy system. There are three key ways for Canada to do this:

- First, as energy producer and exporter, Canada can capture opportunities to meet global demand with energy that is produced sustainably and with lower GHG emissions than the competition. Leaving our resources in the ground or landlocked in a saturated North American market will not abate global demand and emissions. What matters is continuous improvement in the intensity of emissions (including carbon dioxide and methane) through the extraction, processing, and transportation of our resources, including the oil sands and natural gas, in particular LNG that can also contribute to the displacement of coal in Asia. More Canadian oil and gas in the global market can mean less, not more, global emissions.
- Second, as developer, user, and exporter of energy technology and innovation, Canada can assist countries, particularly in the developing world, meet growing energy demand more efficiently and more cleanly—and do so profitably for our economy.
- Third, as user of energy, despite a climate and geography that will necessarily entail more energy use per capita and per unit of economic output than for some of our global partners, incite the changes in energy demand and in the domestic energy supply mix, including necessary changes of behaviour, that can bend our emissions curve at the least cost.

The question is what policy instruments must be put in place to help Canada make the best contributions on these three fronts. We consider in an annex to this section, on page 28, the third point in more detail—how to curb our domestic emissions.

Conclusion

Through this difficult decade from 2008, business and governments have concentrated their efforts on recovery from the painful impact of the great financial crisis. The first objective was to recover the ground lost in the great recession and then to repair public private balance sheets that had been damaged in the recovery effort. Only in the last two years can we say that growth has been robust and that the output gap that opened up in 2008 has been closed in North America and a few other advanced economies.

But, while business and governments have been focused on recovery and protection of existing jobs, knowledge has been advancing so that the economic and technological environment we will face in the 2020s will present qualitatively different challenges than it did prior to 2008. In this section, we have tried to briefly address four of these challenges, not to provide solutions but rather to raise the questions that need to be addressed by business and governments as they formulate their strategic plans.

Our list of challenges is far from complete, but we hope it is helpful in shifting the focus to longer term issues.[48] How government chooses to align policy instruments to meet these four challenges is a matter that deserves considerable debate. But a policy framework to address these challenges must be set in order to provide businesses and households with the appropriate and efficient incentives to make decisions which will enhance their individual and collective welfare over the medium to long term.

Annex to Section IV: Carbon Pricing and the Federal Backstop

While there is general agreement that Canada must contribute its fair share of global efforts to address climate change, and reduce its emissions of GHGs, there is intense debate about how, and how fast, households, businesses and governments should make this contribution. There are sharply divided views about the policies that governments should put in place to induce consumers and businesses to reduce emissions and about the allocation of the short-run costs of emission reduction. Carbon pricing is a focal point of the debate. It is pertinent to reflect on how carbon pricing can work in theory, what issues it poses in practice, and how the Government of Canada's current policy, including the federal Backstop, may apply.

Carbon Pricing in Theory and Practice

Economists generally agree that in a market economy, price signals constitute the lowest-cost way of inducing changes in behaviour such as needed over time to reduce emissions of GHGs. While any policy that aims to lower domestic emissions below a business-as-usual scenario will entail short-run costs to the economy, with the benefits of lower global emissions to be realized over the longer term, these adjustment costs can be minimized by creating the right market incentives. By raising the price of high GHG-creating activities relative to the price of activities that create no or little GHGs, businesses and households are given a financial incentive to voluntarily reduce demand for emission-intensive goods and services, shift demand to other activities, and invest, innovate and do things differently based on their own preferences and opportunities. In effect, the market decides where the GHG reductions can be achieved most cost effectively in the economy.

While economic theory is clear on the merits of carbon pricing, and while some examples such as the carbon tax in British Columbia have been implemented sustainably, there is, in practice, no easy or complete solution and no mechanism that does not involve some policy trade-offs.

There are different ways to apply a carbon price, including a carbon tax at a rate set by the government or a cap-and-trade system where the government sets an emissions cap and lets the market establish the price at which emission permits will be traded. For a small open economy like Canada, theory would hold that a uniform structure of carbon pricing applying across the country would be the most efficient means of reducing GHGs, subject to a number of conditions:

- First, some border adjustment, or some accommodation for large trade-exposed emitters, is necessary such that Canada does not effectively tax exports, subsidize imports, and hence simply displace emissions to other jurisdictions, with no net environmental benefit but a net economic cost. In other words, attention must be paid to global competitiveness.
- Second, net proceeds from the carbon-pricing system have to be used in a way that helps offset the economic costs of the adjustment and/or the distributional effects of the system. In our federal system, a first reasonable condition is that revenues be allocated to, or reinvested in, the provincial or territorial jurisdiction where the proceeds are levied. The judicious use of proceeds is an important factor for the overall efficiency of the scheme and for its actual and perceived fairness for consumers, businesses, and regions.
- Third, the price needs to be set at a level that will not cause severe dislocation and it must evolve over time in a predictable and affordable manner to facilitate ongoing, efficient adjustment. If the price is set too low, it will not have the desired effect on emissions. If it is set too high, too fast, assets will be stranded and adjustment will impose a severe economic cost. If it is unpredictable, it can inhibit investment for the medium to long term.

The Government of Canada's Approach and the Federal Backstop

The Government of Canada's approach to national carbon pricing has been legislated under the *Greenhouse Gas Pollution Pricing Act, SC 2018, C-12, s 186*. It aims to ensure that application of a price to GHG emissions from a broad set of sources by implementing, effective in 2019, a federal Backstop where provincial or territorial jurisdictions fail to meet a federal Benchmark. The approach is responsive to the conditions necessary for an effective carbon-pricing system but it illustrates some of the technical, legal and political difficulties of implementation.

Technically, the federal approach is complicated, in particular, by the recognition of both an explicit price-based system and/or a cap-and-trade system as capable of meeting the federal Benchmark. The Government of Canada has established that this may accommodate different models, from the British Columbia carbon tax, to the Québec cap-and-trade system linked to California as part of the Western Climate Initiative, to the Alberta approach of a carbon levy and separate pricing system for large emitters (Climate Competitiveness Incentives). The Government has also determined that the carbon-pricing systems in Nova Scotia, Newfoundland, and the Northwest Territories are on track to meeting the federal benchmark. In other jurisdictions, the federal Backstop will apply in whole or in part.

The federal Backstop itself is structured as a hybrid-pricing system along the lines of the Alberta model. It includes a fuel charge that will apply to gasoline, heating fuel, and other prescribed liquid, gaseous, and solid fossil fuels at a rate of $20 per tonne of carbon dioxide equivalent (CO_2e) in 2019, increasing annually, until it reaches $50 per tonne of CO_2e by 2022. For consumers and small businesses, this will mean, for example, an added charge of 4.42 cents per litre of gasoline in 2019, rising to 11.05 cents per litre in 2022. Fuel that is imported in the Backstop jurisdiction (from another province or from outside Canada) will be taxed and fuel that is exported will be exempt. This will have the effect of a border adjustment for this part of the pricing system. Some exemptions will apply, for example for farmers and fisherman. Industrial facilities will also be exempt from the fuel charge where subject to the Output-Based Pricing System (OBPS), as described below.

The OBPS will apply to industrial facilities that have reported emissions of 50,000 tonnes of CO_2e or more per year during any calendar year between 2014 to 2017. Facilities that have reported emissions of at least 10,000 tonnes, and less than 50,000 tonnes, for any year starting with 2017, can also opt-in to the OBPS (and be exempt from the fuel charge). Under the OBPS, firms will pay a carbon price based on the difference between their emissions during the year and a standard based on an intensity of emissions 20% below the average in their industrial sector. Firms with emissions below the standard will earn credits that they can bank or sell. Firms with emissions above the standard will pay the equivalent of the fuel charge on these emissions or else buy credits or use previously banked credits. The parameters of the OBPS are intended to mitigate potential damage to competitiveness for Canadian industrial producers in the absence of an international framework for application of border adjustments for carbon pricing in trade of goods and services.

Under the federal backstop, the fuel charge will apply in Saskatchewan, Manitoba, Ontario and New Brunswick, effective April 1, 2019. The OBPS will apply partially in Saskatchewan (to fill in gaps relative to the Benchmark for large emitters) as well as in Manitoba, Ontario, New Brunswick and Prince Edward Island, effective January 1, 2019 (retroactively since regulations will be finalized in the course of 2019). The federal Backstop will also apply in the Yukon and Nunavut later in 2019. Where the federal Backstop applies, revenue raised from the fuel charge will be returned to the same jurisdiction. Where the jurisdiction chooses to adopt the federal system (Yukon and Nunavut), revenue will be returned directly to the governments. In other jurisdictions that do not meet the federal Benchmark (i.e., Saskatchewan, Manitoba, Ontario and New Brunswick), revenue from the fuel charge will be paid to individuals and families in the form of a Climate Action Incentive, with some funds also rebated to cities, schools, hospitals, businesses, and Indigenous communities. The Government has also committed to return revenue from the OBPS to the respective jurisdictions through future climate actions, with details to be announced in 2019.

The federal Backstop is intended not only to ensure some equivalency of carbon pricing across the country in 2019 but also over time as the Benchmark price rises to $50 per tonne by 2022. To date, only British Columbia has set out a track to meet this standard; it recently increased its carbon tax rate to $35 per tonne, with further planned annual increases of $5 per tonne until the tax reaches $50 per tonne in 2021. The Province of Alberta, for its part, has withdrawn its support for the federal Backstop insofar as it imposes a carbon price in excess of $30 per tonne, while impediments to proceeding with the Trans Mountain Pipeline Expansion project remain outstanding.

Table 3

APPLICATION OF FEDERAL BACKSTOP BY JURISDICTION, 2019

Province or Territory	Fuel Charge Effective April 1	OBPS Effective January 1	Fuel Charge and OBPS Effective July 1
Saskatchewan	x	x (partially)	
Manitoba	x	x	
Ontario	x	x	
New Brunswick	x	x	
Prince Edward Island	x	x	
Yukon			x
Nunavut			x

The Fiscal, Economic and Policy Consequences

The revenues derived from the fuel charge and the rebates paid will be substantial. For Ontario, for example, the federal government projects proceeds, and payments, to grow from $1.7 billion in 2019-20 to $4.2 billion in 2022-23. However, the federal initiative is not expected to have a measurable macroeconomic impact, at least in the short term. Monies stay in each respective jurisdiction. Changes of behaviour will happen only gradually and so the impact on economic structure will not be quickly noticeable. There are distributional issues as some households or firms will be better off, others worse off, but overall impacts on output or employment will be small.

The immediate economic and policy challenge is uncertainty. First, a legal challenge to the federal Backstop will play out over the next months and possibly years. The Provinces of Saskatchewan and Ontario challenge the constitutional right of the Government of Canada to impose the carbon price in their jurisdiction. Manitoba has not yet joined Saskatchewan and Ontario in their legal actions. However, it announced in October 2018 that it does not support the application of the Backstop to Manitoba and will no longer proceed with the carbon tax component of its "*Made-In-Manitoba Climate and Green Plan*". The constitutional issue is defended by the Government of Canada under the national concern branch of the "*peace, order, and good government*" power, and alternatively as a tax measure (the federal government has virtually unlimited power under the Constitution to impose a tax). Until such time as the challenge is resolved definitively—and this may require going to the Supreme Court—the signals to Canadian households and firms will remain blurred.

Second, political forces provide that even if legally affirmed, the carbon-pricing regime may still be unstable. The co-existence of different pricing regimes across jurisdictions will involve tensions because provinces will be attentive to differentiated levels of efforts or outcomes as the price implied by the federal Benchmark rises over time. Moreover, the carbon price is only one of a mix of policy instruments that the federal government and the provinces and territories are pursuing and contemplating to address their climate change objectives. Complementary or alternative instruments, from regulation, to incentives for innovation, to reforestation or to the acquisition of international credits, also each have their level of complexity, benefits and costs. Indeed, the removal of carbon pricing by any other instrument would also involve difficult trade-offs.

How governments over time will chose and align policy instruments to achieve environmental and economic objectives and goals clearly remains a matter of considerable debate. This makes the business of planning harder for individuals and firms making decisions for the medium to long term. Firms will be well advised to build in different scenarios in their planning, including what are called shadow carbon prices that may help inform their choices for large capital investment.

Section V:
Some Planning Parameters for Canadian Businesses

We advise businesses to plan on the assumption that global growth in 2019 will be slower than this year's 3.7% but still relatively strong at 3.5%. In the United States, growth will slow to 2.5% in 2019 but will be the strongest among the advanced economies. Global growth should slow to its potential rate of about 3.3% in the two subsequent years. WTI oil prices can be assumed to fluctuate around US$60–65 over 2019-21 as supply adjusts to lower demand growth. It can also be assumed that the WCS heavy oil price discount to the WTI price will remain above traditional levels until sufficient new capacity is added to transport Canadian oil to markets, sometime in the early 2020s.

Based on the above scenario, businesses should plan on the basis of Canadian growth averaging about 2% during the next year and a half and slowing subsequently to 1.7%, its estimated potential rate, by early 2021. We think the risks are slightly tilted to the downside in the short term, primarily because of the risks to the international conjuncture.

We think that it is reasonable for businesses to base their financing plans on the assumptions that the Federal Reserve will raise its target federal funds rate (upper limit) to 2.5% by the end of 2018 and to 3.0%–3.5% by the end of 2019, with little chance of a further increase thereafter. Likewise, the Bank of Canada is likely to hold its policy interest rate at 1.75% at the end of 2018. On the basis of current economic projections, the Canadian policy rate should reach a maximum of 2.5%–3.0% by early 2020, with little chance of further increase thereafter. The 10-year U.S. Treasury bond yield can be assumed to top at about 3.5% by late 2019 and the 10-year Canada bond rate at a little lower level than that.

Based on our assumptions concerning oil prices, growth and policy interest rates in the United States and Canada, we judge it appropriate to plan on the basis of an exchange rate moving in a fairly wide band centred on 76-77 U.S. cents.

Table 4

KEY PLANNING PARAMETERS FOR 2018-21

	2018	2019	2020	2021
U.S. GDP Growth (%)	2.9	2.5	1.8	1.8
Canadian Growth (%)				
Real GDP	2.1	2.0	1.8	1.7
Household Consumption	2.3	2.1	1.8	1.8
Business Non-Res. Investment	6.4	3.7	2.8	2.3
Interest Rates (Year-End) (%)				
BOC Target Overnight Rate	1.75	2.75	3.0	3.0
10-Year GOC	2.6	3.25	3.25	3.25
10-Year U.S. Treasuries	3.1	3.5	3.5	3.5
U.S. Target Fed Funds Rate (Upper Limit)	2.5	3.0–3.5	3.5	3.5
Exchange Rate US$/C$ (Year-End)	0.76	0.76	0.77	0.77
WTI Oil Price (US$/bbl)	65	60-65	60-65	60-65

1. Enbridge's Line 3 pipeline expansion, which will add 380,000 barrels a day of capacity, is expected to enter service in the second half of 2019.

2. On June 15, the United States announced a 25% tariff on imports from China worth $50 billion; China announced retaliation on a similar scale. On September 17, the United States announced a 10% tariff—rising to 25% by year end—on an additional $200 in imports from China. In turn, China announced tariffs on a further $60 billion of U.S. imports.

3. In fact, the expected normalization of interest rates alone could have been sufficient to depress stock prices since it implies that expected future earnings would need to be discounted at higher interest rates.

4. Our 0.3% markdown in global growth for 2019 since last spring compares with a 0.2% markdown by the IMF.

5. We assume that no new tax cut or spending programs will be passed by Congress in 2019 or 2020.

6. This estimate is from the Bank of Canada. See *Monetary Policy Report*, October 2018.

7. See Bank of Canada *Monetary Policy Report*, October 2018, Gavyn Davies, "Can macro policy easing still rescue China?" in *Financial Times*, September 18, 2018, "Trade war: how will Donald's Trump tariffs on US$200 billion of goods affect China's GDP?" in *South China Morning Post*, September 18, 2018, and "China needs policy toolbox to fend off financial risks", in *Global Times*, September 13, 2018.

8. The Bank of Canada estimates the rate of potential growth at just above 6% in 2020. See *Monetary Policy Report*, October 2018.

9. According to a Chinese analyst "It would be acceptable to Chinese policymakers and most of the Chinese public if the world's second-largest economy expands 6 percent annually, taking into account the unprecedented trade war against China by the Trump administration. See Wen Sheng, "China needs policy toolbox to fend off financial risks", in *Global Times*, September 13, 2018.

10. The seven countries which have ratified the CPTPP are Australia, Canada, Japan, Mexico, New Zealand, Argentina, Singapore, and Vietnam.

11. Argentina, Australia, Brazil and South Korea have been exempted from the duties although the Americans are working through how to restrain their exports by quotas.

12. See The heavyweight rivals—America's new attitude towards China is changing the countries' relationship; The Economist October 28, 2018 https://www.economist.com/briefing/2018/10/18/americas-new-attitude-towards-china-is-changing-the-countries-relationship

13. https://www.whitehouse.gov/briefings-statements/remarks-vice-president-pence-administrations-policy-toward-china/

14. https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/september/joint-statement-trilateral

15. http://europa.eu/rapid/press-release_STATEMENT-18-4687_en.htm

16. https://insidetrade.com/trade/trump-us-negotiating-eu-position-%E2%80%98total-strength%E2%80%99

17. https://ustr.gov/sites/default/files/20181017004903138_2.pdf

18. https://ustr.gov/sites/default/files/20181017004930805-3.pdf

19. https://www.whitehouse.gov/briefings-statements/joint-statement-united-states-japan/

20. https://ustr.gov/sites/default/files/20181017004828790-1.pdf

21. https://insidetrade.com/daily-news/nftc-head-%E2%80%98broad-and-deep-support%E2%80%99-usmca-business-community

22. The text of the agreement still subject to legal scrubbing can be found at https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement/united-states-mexico.

23. https://www.bennettjones.com/en/Publications-Section/Updates/Introducing-the-US-Mexico-Canada-Agreement-USMCA

24. http://international.gc.ca/trade-commerce/trade-agreements-accords-commerciaux/agr-acc/usmca-aeumc/summary-sommaire.aspx?lang=eng

25. A curious feature of this trilateral relationship is that the government procurement disciplines among the parties are found in three different agreements. As noted above the Canada-U.S. disciplines are in the WTO Agreement on Government Procurement. The U.S.-Mexico disciplines are in the USMCA while the Canada-Mexico disciplines are in the CPTPP.

26. The Commission is created by Article 30 of the USMCA to administer the agreement. It is composed of government representatives of each Party at the level of Ministers or their designees.

27. Speech to the inaugural International Trade Banquet hosted by the Lord Mayor of London and Secretary of State Liam Fox, October 17, 2018.

28. Dispute statistics are as of November 12, 2018.

29. Canada was also on the receiving end of a challenge from Australia concerning marketing of wine in grocery stores, but this matter has been resolved.

30. They are Ujal Singh Bhatia from India, Thomas Graham from the United States, and Hong Zhao from China.

31. See Concept paper on the modernization of the World Trade Organization, European Commission, September 18, 2018; Strengthening and modernizing the WTO: Discussion paper, communication from Canada,

September 21, 2018; Joint statement on Trilateral Meeting of the Trade Ministers of the United States, Japan, and the European Union, May 31, 2018; Joint statement on Trilateral Meeting of the Trade Ministers of the United States, Japan, and the European Union, September 25, 2018.

32. May 31, 2018 and September 25, 2018.

33. The ministers in attendance were from Australia, Brazil, Canada, Chile, European Union, Japan, Kenya, Korea, Mexico, New Zealand, Norway, Singapore, and Switzerland.

34. In a joint communiqué issued at the close of the Ottawa meeting, WTO ministers stressed the "indispensable role that the WTO plays in facilitating and safeguarding trade" and set themselves the following tasks: address the concerns about the functioning of the dispute settlement system and advance ideas to safeguard and strengthen it; reinvigorate the negotiating function of the WTO, including updating the rules to reflect 21st century realities (such as addressing digital trade, distortion of competitive conditions through market-distorting effects of state-owned enterprises, transfer of technology, and trade secrets); develop a new approach for accommodating different levels of development in rule-making efforts, which refers to the disagreement among Members over economies like China receiving the same flexibilities in taking on trade commitments as afforded to less developed economies; and strengthen the monitoring and transparency of Members' trade policies, which seeks to improve compliance among Members with the requirements under the various WTO agreements to notify trade policies and measures (news-nouvelles@international.gc.ca).

35. Canada is the third most frequent user of the WTO dispute settlement mechanism in terms of filing complaints, standing only behind the United States and the European Union. The United States has filed a total of 123 cases since 1995 and has been on the receiving end of 151 disputes. The European Union numbers are 99 and 85, respectively. (These numbers are current as of November 12, 2018.)

36. Vietnam has now become the 7th country to ratify.

37. These include a new stress-test for low loan-to-value mortgages whereby federally regulated financial institutions are required to vet borrowers' applications using a minimum qualifying rate equal to the greater of the Bank of Canada's five-year benchmark or their contractual rate, plus two percentage points. Stress tests for high-ratio mortgages had been introduced a year before.

38. The Bank of Canada expects the revised guidelines to subtract 0.2% from the level of GDP by the end of 2019. See *Monetary Policy Report,* October 2018.

39. We have based our outlook on the assumption that the USMCA will be signed and ratified as negotiated in all three countries. But, there is a risk that it will not. See Section II on international trade.

40. This projection makes use of Statistics Canada medium growth demographic projection (M1) to establish the age structure of population over 2018-28. This projection dates back to 2014. We think that the projected growth rate of population 15+ over 2018-2028 errs on the low side and consequently have raised it from 0.90% per annum to 1.0% per annum.

41. We expect that the prime-age (25 to 54) female participation rate will continue to rise in the next decade but at a significantly slower pace than in the last seven years, from 82.9% in 2017 to 83.5% in 2028. With additional policy incentives, this might realistically be raised a little, perhaps to 84 or a bit higher. Measures that would help raise the participation rate of women with young children would be particularly helpful and including improved childcare support.

42. For a more complete analysis of the productivity challenge, see Peter Nicholson's paper "Facing the Facts: Reconsidering Business Innovation Policy in Canada", IRPP, October 2018. Chart 4.1 is taken from this paper.

43. See the Report of the Expert Panel on the State of S&T Industrial R&D in Canada: CCA, 2018, p. 14.

44. Note that the share of GDP devoted to R&D through the higher education sector is 0.66% in Canada compared to 0.37% in the United States. Of this, HERD, 7.8% is financed by industry. See CCA Report of the Expert Panel on the State of R & D in Canada 2018.

45. Intergovernmental Panel on Climate Change (IPCC), Special Report, Global Warming of 1.5ºC, October 2018.

46. IPCC, Press Release, October 8, 2018.

47. Environment and Climate Change Canada, Canada's 7th National Communication and 3rd Biennial Report to the UNFCC, December 2017.

48. In January, we will publish a paper on the fiscal challenges facing federal and provincial governments.

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