Bennett Jones Fall 2014 Economic Outlook

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We expect a modest strengthening of global growth over the next two years relative to 2013 and 2014, largely originating from the advanced economies, and the U.S. in particular. Growth in the emerging economies as a whole will increase somewhat in 2015 and 2016 relative to 2014, but progress will be constrained by a further projected slowdown in China. Even though this outlook shows much the same growth dynamics as before, it embeds a slightly more pessimistic view of growth prospects in the short term. Indeed, global growth remains lower than in our spring outlook all the way to 2016 in spite of projected lower oil prices.

Section I presents recent world economy dynamics and the global outlook for 2014-2016, including prospects for Canada. Section II outlines a base-case scenario for global growth over 2017-2020. Our purpose is twofold: to draw attention to factors or developments that are likely to shape growth prospects beyond the short-term horizon and to give an idea of the most probable range of growth rates to be expected as the medium term starts unfolding. Section III briefly examines prospects for global trade growth and discusses where things stand with respect to international trade arrangements and negotiations, including Canada's North American trade agenda and U.S. trade policy after the recent mid-term elections.

Section I: Global Short-term Outlook: 2014-2016

Recent World Economy Dynamics

The world economic recovery lost steam in the first half of 2014 as once again a combination of transitory, cyclical and structural headwinds brought growth down below potential in many large economies. There were some bright spots: strong U.S. output growth in the second and third quarters, robust growth in the U.K., and strengthening growth in India. But mostly there were setbacks. Foremost among them were a decline of output in the large core economies of the euro area (Germany, France and Italy) in the second quarter and almost no growth in the third quarter, a more severe than expected contraction of activity in Japan, and an appreciable slowdown in Latin America, notably falling output in Brazil in the first half of the year. China also experienced somewhat slower growth in the first quarter, but since then has maintained overall growth more consistent with the official annual target (7.5 percent) thanks to stimulative policy measures.

In this context, price inflation in the U.S. although rising, still remains below two percent. Most importantly, wage pressures have not started materializing yet, which among other factors provides the Fed with leeway for delaying the first hike in its policy interest rate well into 2015 now that it has terminated its program of bond purchases (so-called QE3). Price inflation has fallen to very low levels in the euro area where concerns about potential deflation in the face of continued below-potential growth have become more widespread. Inflation expectations in the euro area have fallen significantly. To revive stubbornly sluggish demand and to raise inflation expectations, the ECB undertook this fall a series of measures that amount to a significant monetary policy easing. Japan has seen only a modest rise in inflation to a still very low level (excluding the effect of last April's sales tax increase) despite the efforts of the Bank of Japan.

Expectations of earlier increases in policy interest rates in the United States relative to other major economies have prompted a general appreciation of the U.S. dollar against other currencies, including the Canadian dollar. To a limited extent, this should help buttress the recovery in the rest of the world, notably the euro area, Japan and Canada. The appreciation of the U.S. dollar has also put downward pressure on commodity prices denominated in U.S. dollars.

Since last May, U.S. dollar prices for both Brent and WTI crude oil have dropped by about 25 percent, metals and minerals prices have been volatile but on a downtrend since last August, while lumber prices have generally

strengthened modestly. Growing expectations of slower global growth as the new normal, notably for China and Europe, and increasing supply of non-conventional crude and base metal ores have contributed to the recent weakening of crude oil and metals and minerals prices. The fall in the prices of oil and related energy products, if maintained for some time, should stimulate real spending growth in net oil-importing regions, thereby boosting global growth.

Global Short-term Outlook: 2014-2016

The dynamics of global growth over 2014-2016 remain essentially the same in this Outlook as in our Spring 2014 Economic Outlook, notwithstanding significant negative surprises in 2014 and heightened geopolitical risks (Middle East, Ukraine, South China Sea). We expect a modest strengthening of global growth over the next two years relative to 2013 and 2014, largely originating from the advanced economies, and the U.S. in particular. The strong momentum in the U.S. economy experienced since April 2014 is expected to be followed by above-potential growth averaging 2.7 percent at an annual rate from the fourth quarter of 2014 to the end of 2016. This is a much faster rate than the two percent experienced in 2011-2013.[1] Growth in the emerging economies as a whole will increase somewhat in 2015 and 2016 relative to 2014, but progress will be constrained by a further projected slowdown in China. Emerging economies will nonetheless continue to grow at a considerably faster pace than advanced economies.

Much the same set of factors as enumerated in our Spring 2014 Economic Outlook will drive the expected pick-up in growth. For the advanced economies, these factors include: continued easy monetary conditions (easier conditions in the euro area and Japan), a slowdown in the pace at which structural budget deficits are reduced by governments, less deleveraging, and improved confidence in the private sector. For the emerging economies, the stronger external demand from advanced economies, further progress in removing structural impediments to growth, and policy support to demand should enhance growth, although for commodity producing countries this may well be offset by the impact of lower prices for the commodities they produce.

The one factor that has changed markedly since the Spring 2014 Economic Outlook is a fall in the international price of oil. The lower price is expected to persist for a while and boost global growth over the short term.

Even though this outlook shows much the same growth dynamics as before, it embeds a slightly more pessimistic view of global growth prospects in the short term. Indeed, growth remains lower than in our Spring 2014 Economic Outlook all the way to 2016 in spite of the projected lower oil prices. In our view, repeated negative surprises in the data in the last three years point to a significant risk that the 2014 negative surprise partly persists over the short term. The potential root causes of these negative surprises are currently the object of a debate and will be briefly discussed in the second section of this outlook.

Table 1: Fall 2014 - Short-term Prospects for Output Growth (%)

	2013	2014	2015	2016
Canada	2 (2.0)	2.3 (2.2)	2.4 (2.4)	2.3 (2.2)
United States	2.2 (1.9)	2.3 (2.5)	3.1 (3.3)	2.7 (2.7)
Euro area	-0.4 (-0.5)	0.8 (1.0)	1 (1.3)	1.2 (1.5)
China	7.7 (7.7)	7.4 (7.4)	7.1 (7.3)	6.7 (7.0)
World	3.1 (3.0)	3.2 (3.4)	3.5 (3.7)	3.4 (3.6)

*Figures in brackets are from the Bennett Jones Spring 2014 Economic Outlook.

United States

After a fall of output in the first quarter of 2014, real GDP growth rebounded strongly in the second and third quarters (by 4.6 percent and 3.9 percent respectively at annual rates) and is projected to average 2.3 percent for the year as a whole. Annual growth is expected to increase in 2015 to more than 3.0 percent before slowing to a more sustainable 2.7 percent in 2016. Underpinning this robust growth are the following factors:

- consumption and housing investment grow more strongly due to improved household employment and balance sheets, lower oil prices, and favourable demographics (increased household formation),
- business investment picks up,
- federal government action to cut the deficit moderates and state and local spending increases, and
- the Federal Reserve maintains its current policy rate near zero levels until late 2015.

But by 2016, the slack currently present in labour and product markets will have been largely eliminated. Thus modest increases in the policy interest rate can be expected through the year, and CPI inflation should recover to the 2 to 2.5-percent range. Thus the economy is likely to grow slightly above its long-term potential rate of about 2.5 percent.

Other Economies

A weak recovery is expected to take hold in the **euro area**, with growth of 0.8 percent in 2014 edging up to 1.0 percent in 2015 and 1.2 percent in 2016. Slightly less restrictive fiscal policies, more accommodative monetary conditions, better lending conditions, strengthening global demand and a relatively weak currency would support activity. Lower oil and energy prices would also help to revive real spending, provided they did not tip consumer prices into deflation. In fact, lower oil prices may intensify pressure on the ECB to ease monetary conditions further in order to prevent deflation.

In **Japan**, growth is projected to be positive but to remain below 1.0 percent through 2016 as consumption would be held back by weak real income growth. At the same time, recent further easing of monetary conditions through stepped-up purchases of government bonds by the Bank of Japan would help support domestic demand while the recent substantial depreciation of the yen is expected to stimulate real net exports. So far, a very easy monetary policy has failed to decisively revive the economy. Following the upcoming national election, the Bank of Japan may undertake an even more aggressive stimulative policy.

Growth in **China** is projected to decelerate from 7.4 percent in 2014 to around 7.0 percent in 2015 and to between 6.5 and 7.0 percent in 2016 as investment growth, including in housing, decelerates in response to excess capacity and slower credit growth. Nevertheless, a broadly accommodative monetary policy, targeted fiscal measures and lower oil prices would provide support to growth. Growth in **India** is expected to accelerate in 2015 and 2016. **Russia** is expected to continue the low growth performance experienced in 2014. **Brazil** is expected to show only gradual improvement.

Commodities

It is difficult to judge how persistent will be the recent downward correction to oil prices. Futures presently call for a rather flat profile of the WTI price around $75/bbl for the next several years and analysts have substantially revised downwards their forecasts of WTI and Brent prices for the short term. Our outlook for economic growth is consistent with the assumption that the WTI price will not return to the $100 zone in which it evolved in the first half of 2014 until after 2016. The pace of any recovery from the current level will depend importantly on the extent to which increases in global oil demand, as driven by global growth and lower oil prices, exceed increases in non-OPEC supply, which will likely slow as high-cost marginal production fails to materialize. One important implication of this projection of lower oil prices is that the global rate of growth projected in this outlook is moderately stronger than it would have been had our $100/bbl assumption from last spring been maintained.

Metals prices may decline on average in 2015 relative to 2014 as the recent correction carries into early 2015. They would subsequently recover somewhat as markets start tightening in response to earlier cuts in supply and to a pick-up in global demand. North American lumber prices should firm as U.S. building of single-family houses strengthens over the next two years.

Risks

The known economic risks to this global outlook are much the same as in the spring, and again downside risks slightly dominate upside risks. The downside risks include a sharper-than-expected deceleration of growth in China, with adverse consequences for commodity prices and global trade, and stagnation and deflation in the euro area and Japan if policies fail to revive confidence and demand. The upside risks include stronger-than-expected U.S. growth, with particularly favorable effects on Canada, and a further fall in oil prices, with positive effects on the world economy as a whole. Unexpectedly buoyant U.S. growth would lead the Federal Reserve to raise U.S. policy interest rates sooner in 2015 and faster in 2016, and add more strength to the U.S. dollar, at least temporarily.

By far the greater risks are attributable to adverse geopolitical developments, notably a worsening of tensions in Ukraine, the Middle-East, and the South China Sea. In this connection, there is the risk that further sanctions and other actions slow the growth of international trade more significantly (see Section III). There is also some risk that gridlock between the U.S. president and a new Republican-dominated Congress could adversely affect U.S. growth.

Short-term Outlook for Canada: 2014-2016

After a temporary patch of weakness in the first quarter of 2014, when the economy nearly stagnated, real GDP growth in Canada rebounded at an estimated 3.1 percent rate in the second quarter on the strength of exports, household consumption and housing. Real GDP is projected to grow at about 2.3 percent in the second half of 2014 and in the next two years as well, thus slightly faster than the estimated potential growth rate of around 2.0 percent. This would be sufficient to bring actual output in line with potential output by the second half of 2016. Supportive of Canadian growth will be:

- robust U.S. growth, by far the main destination of Canadian exports;
- a weaker Canadian dollar, which has depreciated by nearly 10 percent in the last year and would likely move within a range of 83-90 U.S. cents over the next two years, stimulating real net exports;
- the end of fiscal drag by the federal government, including the stimulative tax and transfer measures just announced; and
- continued low interest rates as the Bank of Canada keeps the overnight rate below 2.0 percent over the period to the end of 2016.

At the same time, there may potentially be a small headwind from lower oil prices. Lower oil prices would depress Canadian terms of trade and on net would tend to hold back real income and real domestic spending in Canada. At the same time, the increased external demand for Canadian goods and services that lower oil prices would bring through higher global growth and a weaker Canadian dollar would boost real net exports and by the end of 2016 largely offset the adverse terms of trade effects.

In light of these factors, growth in exports is expected to be fairly solid by the standards of the recent past. Business investment in sectors other than oil and gas should pick up steam, and so should government spending on goods and services. In contrast, growth in consumption and housing would tend to slow somewhat.

Section II: Global Growth in the Medium Term (2017-2020)

This section presents in broad brush terms a base-case scenario for global growth in the second half of this decade. Our purpose is twofold: to draw attention to factors or developments that are likely to shape growth prospects beyond the short-term horizon covered in the previous section and to give an idea of the most probable range of growth rates to be expected as the medium term starts unfolding.

Early in this decade, at the beginning of the recovery from the "Great Recession", the world economy was thought to be able to sustainably grow at a rate of four percent or a little more without inducing inflationary pressures, based on pre-crisis trends. It was therefore thought that this was the rate on which global growth should settle after a few years, once slack would have been absorbed and policies normalized. These earlier growth expectations have not materialized and, in fact, are not likely to be achieved in the second half of this decade.

It now seems more reasonable to expect that global growth will average three to three-and-a-half percent over 2017-2020 instead of the four percent that many analysts thought would be the new "normal". This downshift would apply both to advanced and emerging economies and it would reflect both demand and supply headwinds.

Table 2: Prospects for Output Growth (%)

	Share of World GDP[2]	2015-2016	2017-2020
Canada	0.02	2.4	1.8
United States	0.16	2.9	2.5
Euro area	0.12	1.1	1.5
Japan	0.05	0.8	0.8
China	0.16	6.9	5.5
India	0.07	5.9	6.5
Rest of the World	0.43	3.1	3.2
World	1	3.5	3.3

On the **demand** side, an important headwind for many countries, including the U.S., would be a continued lack of growth in the real income of middle-class households as a result of globalization and technological changes in the workplace. An increasing fraction of the population in retirement as a result of population aging would also restrain growth in household income and spending in advanced economies. Household deleveraging should no longer pose a significant headwind over the medium term in most economies. However, deleveraging will still be restraining demand in the euro area for many years to come and could become a restraint on household spending in Canada later in the decade. By contrast, in China the headwind to demand in the medium term would mostly come from a downshift in the investment/GDP ratio as the economy gradually rebalances toward more household consumption.

On the **supply** side, slower growth rates in potential output are to be expected. Long-term growth in advanced economies will be constrained by demographic headwinds over the next decades. Demographics have started depressing potential growth via two channels: population aging reduces the aggregate labour force participation rate while past reductions in birth rates cut growth in the number of labour force entrants. Both lead to slower growth in the labour force and potential output. In emerging markets, especially China, the migration from low productivity rural agriculture to high productivity urban manufacturing will slow down. However, the demographically induced slowdown of potential growth in advanced economies will likely be partly offset by rising trend labour force participation rates for the 60+ years of age. Clearly there will be financial pressures on, as well as financial incentives for, these older groups to stay longer in the labour force.

Whether other **structural developments** will provide additional offsets to aging is highly uncertain. As growth in aggregate demand strengthens in the short term, investment growth and capital accumulation are expected to accelerate temporarily. This would tend to raise trend productivity growth temporarily and thereby provide a transient boost to potential growth. This may have a limited, but diminishing positive impact during 2017-2020. However, the key issue is how trend labour productivity growth will evolve once the positive effect of the stronger economic recovery on investment in the short term dissipates. Several analysts have estimated that trend productivity growth in the U.S. and other advanced economies slowed significantly in the early to mid-2000s, before the financial crisis. In the case of the U.S. at least, this appears to reflect a waning of the ICT-induced surge in productivity in the mid-1990s: the more recent slowdown was concentrated in sectors that produce ICT or that use ICT intensively.[3] There is no consensus as to the future path of technical progress and its impact on measured productivity growth in the medium term. Some argue that the pace of innovation and productivity growth will remain modest because many opportunities have already been exploited (ICT in retail trade for instance, or the fact that populations are already highly educated and urbanized). Others expect that an age of accelerating technical progress (*e.g.*, intelligent machines and "big data") is just ahead of us, with a large potential impact on productivity. On balance, we judge that **productivity growth will be moderate** over 2017-2020 and, therefore, will hold back potential output growth.

If our projections for 2015 and 2016 in the previous section turn out to be correct, then global demand and supply would be roughly in balance by the end of 2016 and growth during 2017-2020 will depend on the evolution of the structural factors listed in Box 1. At the global level, it would appear that both demand and potential supply growth will be weaker than one might have projected based on pre-crisis experience. At the global level, demand growth may tend to be weaker than supply growth and not give rise to great inflationary pressures. Thus, the outlook is for lower global interest rates than during the pre-crisis years. But, as the specific factors apply differently across the advanced and emerging economies, the following section provides projections for the major national economies.

Box 1:

Factors Influencing Global Demand

Skewed income distribution:
- restrains consumption growth

Uncertain expectations:
- dampen business investment

Fiscal restraint:
- constrains government expenditures

Low policy interest rates:
- partially offset fiscal restraint

Factors Influencing Global Supply

Population aging:
- reduces labour supply

Less rural/urban migration:
- reduces productivity growth in emerging markets

Technological innovation:
- affects productivity growth in advanced economies

Advanced Economies

We expect growth in the **U.S.** to slow to about 2.5 percent per annum over 2017-2020 from 2.7 percent per annum over 2014-2016. On the demand side, household consumption and housing are expected to remain fairly firm although constrained somewhat by slow growth in the real income of the middle class. Investment demand should be relatively strong and as a result the investment/GDP ratio is expected to rise steadily until 2020. On the supply side, there is much uncertainty about the future strength of productivity growth. With trend productivity growth in a probable range of 1.6 to 1.8 percent, slowing labour force growth would hold down potential output growth for the overall economy to 2.1 to 2.4 percent by 2020.

In the **euro area**, growth is expected to average 1.5 percent over 2017-2020, exceeding potential growth as slack continues to be absorbed late in the decade. Our underlying view is that further easing of monetary policy and more favorable external conditions will set the euro area on a durable path of stronger, albeit comparatively modest, growth. This acceleration of aggregate demand would stimulate investment and tend to reduce structural unemployment so that by 2020 potential growth may have risen to the 1.3 to 1.5 percent range from 1.0 to 1.1 percent in mid-decade. However, there is a non-negligible risk of stagnation in the euro area for the rest of this decade, akin to the experience of Japan in the 1990s and 2000s. Although this is not our base-case scenario at this stage, it is conceivable that persistent low confidence, credit constraints on businesses, continued efforts at deleveraging, flat or declining real income for the middle class, and population aging will undermine demand while the effectiveness of further easing of monetary policy drops. This would have a negative feedback on potential growth via discouraged investment, higher structural unemployment and a fall in the trend labour force participation rate. Growth then might remain below 1.0 percent even late in the decade.

In the medium term, potential growth in **Japan** will be shaped by two main factors. Demographics per se will reduce the levels of the labour force and potential output: the working age population will decline and population aging will depress the aggregate labour force participation rate even with increases in the participation rates of the older age groups. On the other hand, if the Japanese achieve modest success in breaking out of stagnation and deflation in 2015-2016, there are good prospects for a strengthening of investment growth and capital accumulation later in the decade, with positive effects on trend productivity growth, and hence potential growth. All in all, we would expect potential growth in the range of 0.8 percent over 2017-2020.

Emerging Economies

Growth in **China** and several other emerging economies has started to slow down for structural reasons. In China, growth is expected to decelerate further in the second half of this decade as external demand slows, migration to the cities abates, and rebalancing from investment to consumption and from manufacturing to services continues. For quite some time China will have to live with the consequences of past over-investment – notably massive debt accumulation by local governments and property companies. The need to reduce the rate of growth in the credit/GDP ratio, and the fact that the transport and housing infrastructure to accommodate (a slowing) urbanization over the next several years is already in place, will force a slowdown in investment growth. To rebalance the economy, real wages will need to continue to rise, interest rates will need to be liberalized, and the renminbi will need to be allowed to appreciate. This would help to reverse the flow of wealth from the household sector to the state and corporate sectors; but at the same time, it would reduce cost competitiveness and corporate profitability. However, consumption growth will not rise as fast as household incomes. In part, this is attributable to the fact that income growth is skewed toward those with high incomes. And in part, it is attributable to the lack of high-return savings vehicles and the need for precautionary saving given the lack of a public social security and pension system. All in all, the pace of GDP growth is expected to moderate significantly as consumption is not likely to increase as fast as required to offset a projected slowdown in investment and exports. By 2020, China is likely to be growing at five percent or less.

India is expected to achieve somewhat more robust growth toward the end of this decade, mainly through investment and exports, as a result of improved business sentiment, deregulation, government progress in cutting red tape, and

highly favourable demographics. Still, growth in Indian investment and output later in this decade is expected to fall well short of China's performance in the 1990s. With the right macro and structural policies in place and drawing on a young and increasingly educated workforce, Indian growth may, however, accelerate substantially in the 2020s.

Brazil needs to rebalance its economy to bring back projected weak growth in the near term to its three percent historical average and sustain it at or above this rate in the medium term. Unlike China, the rebalancing of demand must be from consumption to investment in order to increase productivity growth, restore cost competitiveness and stimulate real net exports. This will require *inter alia* a rise in domestic saving so as to avoid building up external vulnerabilities by relying on foreign saving to finance the required rise in the investment/GDP ratio. It will also require reduced barriers to trade in both goods and services to increase productivity. We would expect growth to only be in the range of 2.5 to 3.0 percent on average over 2017-2020.

Several other emerging and developing economies will face the headwinds of slowing external demand from the advanced economies and China and of lower real prices for the commodities they produce. A case in point is **Russia**.

Commodity Prices

With global growth less than 3.5 percent in the second half of this decade, prices for crude oil and other industrial commodities would settle in real terms at considerably lower levels than recent peaks. In the case of oil, while prices will no doubt be volatile in response to geopolitical development, the current lower price range ($75 to $100) would tend to persist in the face of moderate demand growth and increasing non-conventional supply. Oil demand growth in the medium term may be further restrained by policies designed to reduce carbon emissions. Prospects for reaching a global climate agreement next year have significantly improved with the recent U.S.-China climate agreement. A global agreement could lead to more regulation of the energy sector. At the same time, increased supplies of LNG should hold down global prices for natural gas, and the cost of solar electricity generation should continue to fall. Likewise, for raw materials in general, including metals, our best guess is that their current lower price range will persist. In addition to the important influence of persistently moderate global growth, the strength of the U.S. dollar exchange rate would weight on commodity prices measured in U.S. dollars. The U.S. dollar would draw its buoyancy from the relative strength of the U.S. economy.

Canada

Over 2017-2020, aggregate demand in Canada on average should increase at roughly the same pace as potential output in the absence of a large economic shock and provided that monetary policy still pursues price stability as we expect. We project growth in both aggregate demand and potential output to slow to about 1.8 percent over 2017-2020 compared with output growth of 2.3 percent over 2014-2016.

On the demand side, one would expect some rebalancing away from household spending toward exports, non-energy investment (including infrastructure) and government spending on services for the elderly. The expected multilateral strength of the U.S. dollar, and the downward level adjustment in the prices of oil and industrial commodities that has already taken place, would likely keep the **Canadian dollar weak**, in a fairly wide range centred on 83-85 U.S. cents in the second half of this decade. The resulting improvement in Canadian cost competitiveness along with the boost to global demand from lower oil prices would stimulate growth in real net exports and business non-energy investment. The stronger external demand for goods and services produced in Canada may largely offset over time the negative impact of lower Canadian terms of trade on real domestic income and spending. But further factors would weigh on domestic demand, particularly household spending. As mentioned earlier, these include trend sub-par growth in the real income of the middle class, an increasing share of the population in retirement,[4] and possibly some increase in the saving rate of working households in response to concerns about high debt levels or about the adequacy of future retirement income.

Potential output growth would tend to slow because demographics would cut labour force growth, notwithstanding further increases in the labour force participation rate of the large 60-69 age cohort. Stronger non-energy investment may boost trend productivity growth somewhat beyond 2016 and partly offset the impact of demographics. All in all, we would expect potential growth to decline from around 1.9 percent in 2016 to about 1.7 to 1.8 percent by 2020.

The best way to support growth in the face of adverse demographics and a slowdown in household spending growth is to increase investment (both public and private) in infrastructure and productivity-enhancing machinery and equipment and process innovation. While federal and provincial governments should balance their operating expenditures with their current revenues, raising investment would tend to boost potential growth, enhance our international competitiveness and stimulate exports. Increased exports in turn would lead to an improvement in our net international investment position and hence national wealth. In a context of permanently slower global growth and competition for export markets, gaining better access to foreign markets through new or improved trade agreements would give Canadian exports a better chance to grow.

Section III: Trade Developments

Uncertain Prospects for Trade Growth

The combination of projected slow economic growth for the coming years, persistent protectionist pressures, and increased geopolitical tensions are putting significant pressure on the growth of international trade. At the same time, slow progress in efforts to implement the results from December's WTO Ministerial Conference in Bali coupled with mixed progress on major bilateral and regional trade negotiations have raised questions about the ability of governments to make trade a positive factor in contributing to global growth.

On November 5, WTO Director-General Roberto Azevêdo issued the WTO's 12th report on G-20 trade measures for the period mid-May 2014 to mid-October 2014. The report shows that the stock of restrictive trade measures introduced by G-20 economies since 2008 continues to rise despite the pledge to roll back any new protectionist measures that may have arisen.

In the last few months there has been a significant scaling back of expectations for trade growth. WTO economists for instance have reduced their forecast for world trade growth in 2014 to 3.1 percent (down from the 4.7 percent forecast made in April) and cut their estimate for 2015 to 4.0 percent from 5.3 percent previously. Uneven growth and continuing international tensions are contributing to continuing downside risks. These tensions could result in additional economic sanctions that while justified on strategic grounds could weaken economic performance.

Clearly strengthening international trade disciplines and further liberalizing trade would help trade make a useful contribution to improving business confidence and strengthening prospects for growth. The remainder of this section discusses where things stand with respect to international trade arrangements and negotiations and describes what has happened since our Spring Outlook.

The dynamic of **competitive trade liberalization** continues to dominate the landscape of trade negotiations. All the major trading countries are vying to secure more liberal access to the world's most attractive markets, resulting in a network of overlapping negotiations aimed at creating free trade agreements. As previously described, the stakes are high because the first country to secure improved access to a particular market can score major advances over its competitors, particularly if the original barriers had a real trade restrictive effect. Competitive trade liberalization creates a different environment for business than the one that existed under a global trading system of uniform multilateral rules largely shaped by the GATT and the WTO. Until recently, with the exception of a few free trade agreements, virtually all suppliers faced exactly the same tariff barriers in key markets. Now, with new agreements with different content being negotiated and implemented in different time frames, the environment in which companies are operating is

much more complicated. In this process of negotiations there have been some significant achievements in the last year, but questions remain about whether Canada and other countries will be able to sustain the ambitious program of trade negotiations that characterized much of past year and a half.

WTO

After six months of delay, India and the U.S. have patched up their differences and work on the implementation of the "Bali" Trade Facilitation Agreement can move forward. Also the U.S. and China have just announced that they have reached a bilateral agreement on the expanded coverage for the WTO Information Technology Agreement (ITA). This breakthrough paves the way for the early completion of the ITA negotiations in Geneva.

The ITA agreement is doubly important because an effective working partnership between the U.S. and China is a necessary requirement for broader progress on WTO negotiations. It may well be that the U.S. will now be prepared to remove its veto on Chinese participation in the Geneva-based Trade in Services Agreement (TISA) negotiations in which 23 countries, accounting for some two-thirds of the world's economy, are already engaged. The capacity of the U.S. and India to work together on trade matters is also a significant plus for advancing meaningful new work in the WTO.

Mega-Regional Negotiations

The so-called mega-regional negotiations are an important part of the trade negotiations landscape, notably the Trans-Pacific Partnership Negotiations (TPP) with 12 participants including the U.S., Japan and Canada, and the TransAtlantic Trade and Investment Partnership (T-TIP) negotiations between the U.S. and the European Union. There is clear political commitment both in the new EU Commission and in the new American Congress to move forward with the T-TIP. On the TPP front, progress has been made in recent months but the elements of a final deal remain elusive. Much may depend on whether the U.S. Congress passes Trade Promotion Authority (see below).

The TPP negotiations have obvious implications for Canada. Reaching a good TPP agreement would benefit Canada through new market access opportunities in Japan and other significant players in South East Asia. In addition, it could well result in some valuable improvements to the 20-year-old NAFTA agreement. Reaching a TPP agreement, however, would require that Canada offer improved market access for products covered by its supply management system. On the other hand, if the TPP falters it may give Canada an opportunity to complete bilateral negotiations with Japan and offer Canadian producers the prospect of getting preferential access to that market ahead of their American competitors.

Ambitious Canadian Trade Negotiations Agenda

The year 2014 began with the successful completion in March of a free trade agreement between South Korea and Canada (CKFTA). Both countries are committed to implementing the CKFTA quickly and expectations are good that parliamentary ratification in both countries will be completed in time to allow actual implementation of the agreement on January 1, 2015.

Progress on the trade negotiations agenda continued with the completion of negotiations with the EU on the Comprehensive Economic and Trade Agreement (CETA). Now that agreement has been reached on CETA, the lengthy process of moving towards implementation has begun. First the text, like that of all treaties, will need to be legally "scrubbed". Second, the agreement will need to be translated into French and the other 22 official languages of the EU and those different versions will need to be legally verified. Third, the agreement will need to be ratified and the necessary changes to legislation made. In Canada this will require action by the Parliament of Canada and by the provinces. In the EU the agreement will need approval by the Council or Ministers (representing the governments of the Member States) and the European Parliament. Subsequently, because the CETA includes matters over which

individual EU Member States still have jurisdiction, it will almost certainly be necessary for the agreement to be ratified by the parliaments of the 28 Member States. In this regard, some social democrat members of the German coalition government have threatened to re-open CETA's investor-state provisions in light of the precedent they set for their negotiations with the U.S. for a free trade pact. However, it should be possible on a provisional basis to implement those elements of the agreement coming under sole EU jurisdiction once approval is received from the European Parliament. This would include tariffs and other provisions relating to basic market access liberalization. Given this scenario it will not be until 2017 that Canadian business will begin to benefit from the new terms of access. It should be noted that technical discussions are continuing on certain administrative arrangements needed for implementing elements of the agreement, such as the regulatory requirements needed to allow unitization of the tariff rate quotas on beef and pork.

The Canadian government is pursuing many other initiatives, including a potentially significant negotiation with Japan to conclude an economic partnership agreement.

Canada's North American Agenda

Of course, the **U.S.** remains Canada's most important trade partner by far. The Government is actively engaged in efforts to remove persistent barriers impeding the conduct of business with the U.S., *inter alia* by advancing the Beyond the Border Action Plan and the work of the Regulatory Cooperation Council. Useful progress has been made but much remains to be done. In the remainder of this section we focus on the significant benefits Canada can obtain by intensifying its partnership with the other North American country, Mexico.

Mexico is one of the most promising growth markets among emerging developing economies. Importantly, under the administration of President Peña Nieto, Mexico has undertaken significant economic reforms which should revitalize Mexican economic performance, especially in energy output.

Canada already has a significant relationship with Mexico. Mexico is the third largest supplier to the Canadian market after the U.S. and China and Mexico is Canada's fifth largest export market, virtually on a par with Japan, both accounting for just over two percent of Canadian exports. Many Canadian businesses, particularly in agriculture, are dependent on temporary Mexican workers, whom they have found to be reliable employees.

While our Government works to negotiate free trade agreements with other emerging markets, Canada already has a first-class trade and investment agreement with Mexico – NAFTA. The recent **Mexican reforms**, particularly in the energy sector, offer major new opportunities for Canadian firms to participate in exploration and development activity as Mexico moves to modernize its exploitation of its oil and gas resources in the Gulf and on land. In addition, in the electricity sector the reforms open up new opportunities for foreign firms in power generation, transmission, and distribution. They will also result in more competitive prices for end users, thereby providing a boost to the manufacturing industry. Canadian firms are now planning how to exploit these opportunities and negotiating arrangements with potential Mexican partners. They have the technological expertise to compete effectively and expand their business in Mexico.

At the government-to-government level there would be great value in working more closely with Mexico on some of the objectives we are separately pursuing with the U.S. A good example is our joint efforts to remove the discrimination against Mexican and Canadian live cattle and swine exports to the U.S. caused by the American Country of Origin Labeling Regulations (COOL) that have been found by the World Trade Organization (WTO) to be illegal. More generally, the potential benefit of co-operation with Mexico in battling U.S. trade irritants such as COOL and Buy America provisions has increased as Mexico has become more influential politically in Washington.

Achieving these valuable objectives would clearly contribute to Canadian economic growth. But to achieve full benefit,

Canada would need to revise its visa policy towards Mexico because the economic co-operation envisaged would require a lot of travel by business and various service providers.

The time has come to strengthen Canada's relationship with Mexico for the 21st century. Prime Minister Harper will host the next North American Leaders Summit in Canada in 2015. This meeting offers an opportunity for Canada to take a leadership role in reinvigorating the North American partnership by building on earlier commitments to strengthen North American cooperation. As part of this, the Government should develop a plan to breathe new life into the Canada-Mexico partnership.

Conclusion

As we approach 2015 the global prospects for trade and successful completion of major negotiations (across the Pacific and Atlantic) remain unclear. In particular, for negotiations with the U.S. to proceed to agreement, the U.S. Administration will need "fast track" Trade Promotion Authority (TPA) from Congress.

The successful passage of TPA will require some votes from Democrats because a number of hard-line Republicans are opposed to such authority. It will, of course, also require a Presidential signature. It is not yet clear whether such bipartisan co-operation will materialize. Republicans will need to decide whether they are prepared to work with President Obama in pursuit of new trade agreements that have strong support from American business. This would require them to forgo the temptation to draft TPA legislation that overrides certain Democratic sensitivities, for instance on labour and environment, and to be prepared to share "victory" with a President with whom they are at odds on many other files. What will happen may not become apparent until after the new Congress takes office in January.

1. The small improvement in U.S. growth for the whole of 2014 reflects a crash of activity in the first quarter due largely to temporary factors.
2. Share of World GDP weights are based on PPP. The source is the IMF.
3. See Fernald, J.G. 2014. "Productivity and Potential Output Before, During and After the Great Recession". Federal Reserve Bank of San Francisco, Working Paper 2014-15.
4. Population aging, however, would also entail faster increases in government spending on healthcare and home care for the elderly.

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