Bennett Jones Economic Outlook

Spring 2011

Two-Speed World Growth To Continue Amid Policy and Price Uncertainties

Recent World Economy Dynamics

Since last fall a number of risks to the world economic conjuncture have emerged or gained in intensity but, at the same time, there have been growing signs that the recovery in advanced countries has finally reached escape velocity and that persistently rapid growth has virtually eliminated spare capacity in large emerging market economies (EMEs). Not surprisingly, advanced economies have increasingly focused their attention on strategies for exit from very accommodative monetary and fiscal policies whereas EMEs have repeatedly tightened their monetary and prudential policies to stem growing inflationary pressures and financial risks. So far the latter have achieved little apparent success in part because the resistance of many of them to letting their undervalued currencies appreciate has deprived them of an effective tool for reducing imported inflation. This is all the more damaging in view of the recent, marked pick-up in the international prices of oil, food and other commodities, with its attendant risk for EMEs of second-round effects into wages and other prices. In advanced economies, the risk from the commodity price shock is slower real aggregate spending rather than higher core inflation, given that excess capacity is still significant, wage growth moderate and inflation expectations firmly anchored. Also weighing at times on financial markets and adding to downside risks have been recurrent concerns about both the debt crisis in Europe's periphery and the fragility of Europe's banks, the protracted weakness of the U.S. housing market, and the uncertain cost and spillovers of the recent earthquake and tsunami in Japan.

What has raised confidence in the prospects for a self-sustaining recovery in advanced economies, notwithstanding the prospect of less stimulative fiscal and monetary policies ahead and moderately adverse terms-of-trade developments recently (for most countries), has been the pick-up in industrial production, business investment, private employment and consumer expenditures. Indeed, final private domestic spending has responded to shrinking excess capacity, healthy corporate profitability and easing financing conditions, while benefitting from reduced job layoffs and some pent-up demand for consumer durables. The underlying normalization of financial behavior by the private sector, albeit not impervious to setbacks in the event of major shocks to confidence, augurs well for sustained but rather subdued growth in advanced economies.

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Major emerging economies, notably China, India and Brazil, have experienced rising inflation rates and rapid credit and asset price growth. Based on past experiences, this raises the risk that the boom may eventually end up in a bust, hence the efforts of their authorities to tighten monetary policy and credit growth in order to secure a soft landing for their economies. Inflationary pressures have intensified not only because of the fast increase in the international prices of food and energy but also because of growing demand pressures on capacity. In the short run, slowing growth in EMEs will have negative effects on advanced economies, but in the longer run it will be beneficial to the world economy by making global growth sustainable.

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The Global Outlook: 2011-2012

Global growth is projected to slow markedly from nearly five percent in 2010 to the more sustainable rate of about four percent per annum in 2011 and 2012. Growth in China and several other EMEs is expected to moderate over the next two years, albeit to still relatively fast rates, in response to tighter monetary and fiscal policies, elevated commodity prices, and an appreciation of their real effective exchange rates. Part of this appreciation reflects much faster rates of domestic price inflation in EMEs than in advanced economies, which could persist over the next several years. It may well be that with more priority given to combating inflationary pressures, China will allow more appreciation of its nominal exchange rate as well. The greater tightening of monetary and credit policies in EMEs relative to advanced economies in the short term will result in further large capital inflows and upward pressures on EME currencies. At the same time, still robust demand growth in EMEs in the context of the projected soft landing will underpin firm commodity prices.

Barring a significant worsening of oil supply disruptions and consequent spiking of oil price, the momentum of advanced economies in 2010 is expected to carry over into 2011 and to a lesser extent 2012, except in Japan because of the earthquake and a very strong yen. Growth in the United States is projected to be close to three percent and in the Euro area slightly less than two percent. Stronger labour markets supporting household spending, solid expansion in business investment in machinery and equipment, and modest gains in real net exports should help to maintain a moderate growth path even as domestic fiscal policies tighten. While headline CPI inflation may show broad gyrations in response to movements in energy and food prices or in indirect taxes, core inflation rates are expected to converge on their implicit or explicit targets as excess supply is gradually reduced and the prices of non-commodity imports increase faster.

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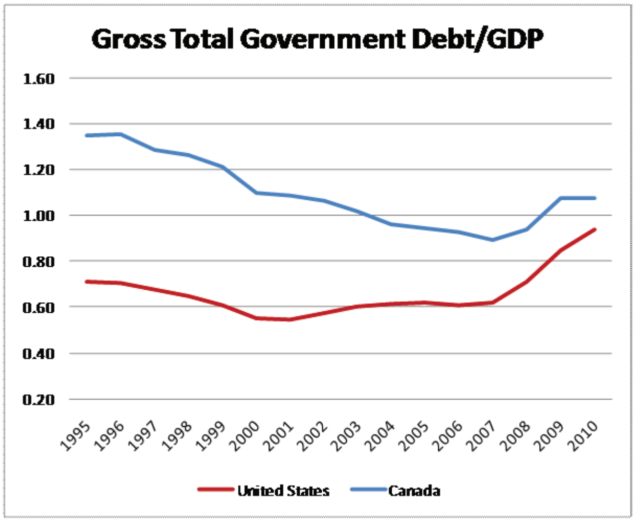
While the risk of a double-dip recession in advanced economies now appears to be minimal, there is still considerable uncertainty about the strength of the expansion in the short term. Downside risks arise from the possibilities of worsening oil supply disruptions, weaker housing prices, more household deleveraging, insufficient progress in stemming inflationary pressures and credit risk build-up in EMEs, and uncertainty about the resolution of the sovereign debt crisis in the Euro area.

Short-Term Prospects for Output Growth (%)

	2009	2010	2011	2012
Canada	-2.5	3.1 (3.0)*	2.8 (2.3)	2.5 (2.5)
United States	-2.6	2.9 (2.7)	2.8 (2.3)	3.0 (3.0)
China	9.2 (9.1)	10.3 (10.3)	9.0 (9.0)	9.0 (9.0)
World	-0.5 (-0.6)	4.9 (4.7)	4.0 (3.8)	4.0 (4.0)

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

With the recession and financial crisis, the governments of advanced countries saw their deficit and debt expand rapidly (Chart 1). For the advanced countries as a whole, a reduction



N.B. Debt data from U.S. flow of funds accounts and Canadian national balance sheets accounts. Total government debt includes the gross liabilities of federal, provincial/state and local governments.

of the cyclically-adjusted general government balance as a percentage of potential GDP will start this year, but at a somewhat slower pace than was expected last fall because fiscal consolidation has been delayed to 2012 in the United States and Japan. In the Euro area and the United Kingdom, on the other hand, tightening should be particularly severe in 2011. Overall, discretionary fiscal consolidation cumulates to 1.5 percent of potential GDP over the next two years in advanced economies.

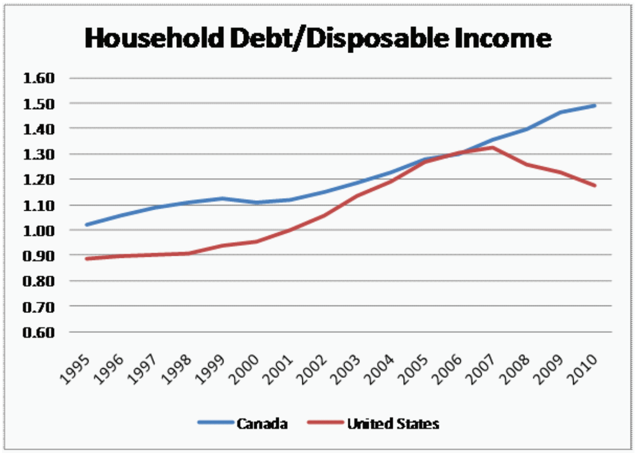
Financial Outlook

Expectations regarding the vigour of private domestic demand and exports over the short term as well as the effects of fiscal retrenchment (or lack thereof) are key factors in monetary policy decisions in advanced economies, given the perceived current state of excess capacity and level of core inflation. The diversity of circumstances facing countries and slightly different degrees of tolerance for risks on the inflation side across central banks mean that the timing and speed of monetary policy tightening should differ across countries over the short term. In early April, the ECB was the first of the leading central banks to raise policy rates. It has since held back on further increases. For the United States and the United Kingdom, the strategy of an eventual exit is made more complex by their reliance on quantitative easing, which acted as an alternative to policy rate cuts after those rates reached their zero lower bound. Be that as it may, long government bond rates have already risen noticeably from their lows of last summer, reflecting investors' expectations of both higher inflation and higher real yields due to anticipated monetary policy tightening.

Although on the rise, policy interest rates in advanced economies are expected to remain relatively low even by the end of 2012, and much lower than in EMEs. This will encourage excess leveraging, search for yield and carry trade, with likely further downward pressures on the U.S. dollar. Along with generally narrow risk spreads, cheap money may well stimulate mergers and acquisitions, somewhat as it did over 2005-2007. On the other hand, bank lending to small- and medium-sized enterprises is likely to remain somewhat constrained as banks strive to meet more stringent capital requirements while still dealing with legacy problems from the financial crisis. One should expect considerable volatility in securities and exchange rate markets over the short term.

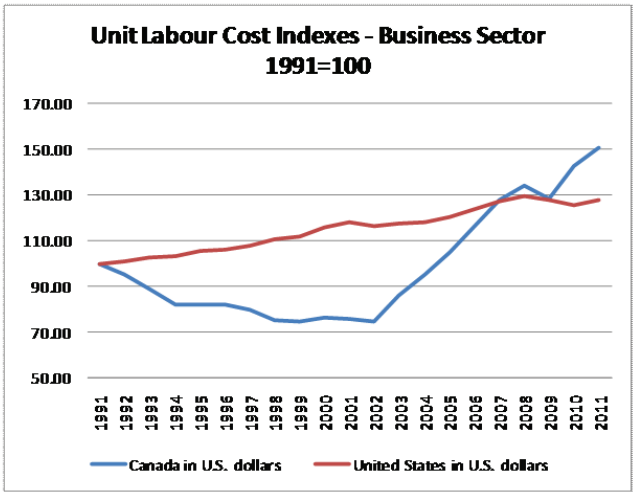
Outlook for Canada

Growth in Canada is projected to gradually moderate over the short term and converge towards its lower potential rate as economic slack is taken up. A steady, if unspectacular, expansion in the United States would feed exports while high commodity prices would buttress business investment and consumer spending, the latter through gains in terms of trade and wealth. On the other hand, fiscal consolidation at the federal and provincial levels would cut income and spending, households would keep their consumption in line with disposable income in view of their high level of indebtedness (Chart 2), housing investment would make no contribution



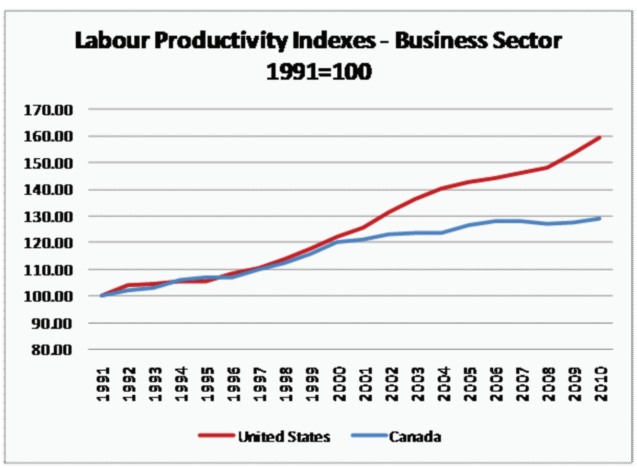
N.B. Household debt here includes consumer credit, loans and mortgages, but excludes trade accounts payable.

to growth, and a much deteriorated competitiveness would hamper real net exports (Chart 3). This deterioration



N.B. The 2011 value for the U.S. reflects the year-over-year growth rate in 2011:Q1; for Canada it reflects the growth in the average level of the Canada-U.S. exchange rate in the first 5 months of 2011 relative to its average 2010 level.

essentially stems from a stronger Canadian dollar and weaker productivity growth than in the United States (Chart 4). Further



difficult adjustment to the appreciation of the Canadian dollar is to be expected in Canadian manufacturing, a sector that is particularly exposed to exchange rate movements in view of its high degree of openness.

Some Implications for Canadian Business

Most of the implications denoted in the Bennett Jones Fall 2010 Economic Outlook still hold. The recent rise in commodity prices would lead to stronger margins for many commodity producers, and boost real income and the demand for goods and services in the Western provinces and Newfoundland and Labrador. This in turn provides all Canadian establishments with more ample opportunities for sales in these markets. In the short term, a higher Canadian dollar reduces margins for Canadian firms competing with foreigners in foreign and/or domestic markets. Businesses could take the opportunity of robust balance sheets, a stronger Canadian dollar and still favourable interest rates and credit conditions to acquire at lower cost productivity-enhancing machinery and equipment. This would mitigate somewhat the negative impact of the higher dollar on their competitiveness. In view of the significant volatility in financial and foreign exchange markets to be expected in the short term, businesses would also benefit from careful hedging and risk management strategies.

Implications of Recent Budgets in Canada

Canadian governments face a period of significant fiscal retrenchment in the years ahead. In past months, the governments of Canada,[1] Ontario, Québec and Alberta have released their 2011 budgets. All four governments project to bring their budgets into balance over horizons ranging from 2012-2013 in Alberta to 2017-18 in Ontario. In all cases the economic and revenue projections are well within plausible ranges. Where the budget projections are quite problematic is with respect to the projected growth in total program spending, which is very low for many consecutive years. Even allowing for very slow growth in health care spending relative to historical trends and our own projections,[2] this implies that spending on a fair chunk of government services falls year after year, notably in Ontario and Québec.

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Past experience suggests that there is an important risk that, after a few years of compression, program spending will rebound with a vengeance once the general fiscal situation improves, either because of large, pent-up demand for public services or partial wage catch-up in the public sector, or both. In the federal budget, program spending excluding transfers to other administrations only edges up between 2010 and 2015 while these transfers are unrealistically projected to grow somewhat less than nominal GDP in Canada over the same period. Pressures on the federal government for both increases in fiscal transfers and a re-arrangement of the sharing of financial resources within the federation (equalization) will intensify dramatically over the next few years.

The need for fiscal consolidation is particularly great in Ontario because of its considerable deficit relative to GDP and in Québec because of its high net debt relative to GDP. Debt service payments grow faster than nominal GDP and own-source revenues in these two provinces, even if for Ontario there is virtually no allowance for increases in the average interest rate on the debt up to mid-decade. In Alberta, high oil prices and an expansion in unconventional oil production greatly boost resources revenue in 2012 and 2013, but these revenues from non-renewable resources should be allocated to capital investment rather than current services.

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1. A new federal budget will be submitted once the House of Commons reconvenes. Indications are that it will be very similar to the one submitted last March.
2. Our base case calls for average annual growth in total (public and private) health care spending in Canada of about 6.5 percent between 2009 and 2016. This compares with 8.3 percent between 1975 and 2009 and 6.6 percent between 1995 and 2009. See D.A. Dodge and R. Dion, "Chronic Healthcare Spending Disease: A Macro Diagnosis and Prognosis", *C.D. Howe Institute Commentary*, No. 327, April 2011.

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