Bennett Jones Economic Outlook

Continuing Factors Influencing Growth

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As we explained in our fall 2011 economic outlook, there are three major factors influencing short-term global economic performance that businesses should be aware of when setting their plans.

First, as a legacy of the financial crisis, deleveraging in the financial, household and government sectors will constrain economic growth to below-trend levels in many advanced economies. Second, strong growth will continue in emerging market economies (EMEs), although at rates somewhat below those in recent years, particularly in China, which has become relatively more reliant on domestic demand to drive growth. Third, how economic policies adjust to growth prospects and internal imbalances will play a crucial role. In all markets, there is a heightened degree of uncertainty with respect to economic policy as governments in advanced economies deal with the political consequences of deleveraging and governments in the EMEs, particularly China, struggle with the domestic politics of adapting to slower growth of external demand.

Recent World Economy Dynamics

In our fall 2011 economic outlook for 2012, our baseline scenario of "policy adjustments without further crisis" envisioned a significant slowdown of the global economy resulting from (i) stagnation in the Euro area, (ii) no acceleration in U.S. growth from its tepid pace in 2011, and (iii) slower but still strong expansion in China. While the European Central Bank's long-term refinancing operations alleviated a bank funding crisis and improved financial conditions this year, the recent economic and fiscal policy actions of governments (more austerity) have meant that the immediate growth prospects of European economies have worsened. Recent political developments in Holland, France and Greece may lead to reduced austerity measures but cast more doubt on financial stability in the eurozone as a whole.

Overall, new information on economic developments has only slightly altered our views on global growth in the short term, but has changed our projections of where that global growth will come from.

The recent dynamics that shape our views include the following developments: (1) the Euro area experienced a marked contraction at the end of 2011, and high-frequency indicators suggest that the economy is still shrinking.

Factors influencing the economic outlook continue to be: deleveraging in advanced economies, strong growth in emerging markets, and a heightened degree of political and policy uncertainty in Europe and the United States.

Moreover, there is little confidence that growth can be restored quickly; (2) U.S. output growth has picked up since the third quarter of 2011 and labour market conditions have improved, but the prospects for further rapid employment growth are not strong; (3) growth in China at the beginning of 2012 decelerated noticeably for both internal and external reasons, but some improvement is expected over the next two years; (4) since last December, international oil prices (but not the U.S. WTI price) have increased significantly from already elevated levels, essentially because of concerns about the adequacy of supply; and (5) global financial conditions have eased somewhat.

These "starting point" dynamics point toward less growth during the next two years in the eurozone and China than was projected last fall, but more growth in the United States (and Canada) in 2012 without further improvement in 2013.

Short-Term Outlook: 2012-2013

Global growth is projected to slow again in 2012 – to 3.2 percent from 3.8 percent in 2011 – before edging up to 3.5 percent in 2013. These growth rates are below four percent, the *trend rate* that is generally thought to be the long-term sustainable non-inflationary growth rate for the world economy. The implication is that global unemployment is likely to remain elevated over the next two years. As before, this projection assumes that policy adjustments will forestall further crises. This projection is not without risks, not only with respect to the eurozone but also with respect to the United States, where a so-called fiscal cliff (see below) in 2013 threatens the recovery.

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Much of the sub-par global performance going forward originates from the Euro area, where fiscal tightening, private sector deleveraging and the adverse feedback loops between weak growth, deteriorating fiscal positions, rising bank recapitalization needs, deleveraging and credit constraints on private spending keep the economy in recession over at least the first half of 2012 and severely limit its recovery in 2013. Real GDP is projected to fall by 0.4 percent in 2012 and rise by only 0.9 percent in 2013, still below a longer-run trend growth rate of 1.0-1.5 percent. Net export gains, likely supported by a weaker euro, are the only significant source of output growth. Final spending by households, firms and governments fall in 2012 and stagnate in 2013. Recent political developments suggest growing risks of political resistance to the fiscal compact promoted by Germany and do increase financial uncertainty in the eurozone. In our view, it is unfortunate that in current discussions emphasis is disproportionately placed on the short-term correction of fiscal deficits as opposed to the necessary structural changes to promote growth, especially in periphery economies.

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U.S. growth, on the other hand, picks up from 1.7 percent in 2011 to nearly 2.5 percent over the next two years. This moderate rate, which is probably slightly below the longer-run trend rate, at best should bring only a gradual improvement in the U.S. employment situation from now on. The resultant persistent slack in the economy should militate against any rise in the policy interest rates in the next two years.

Short-Term Prospects for Output Growth (%)

	2010	2011	2012	2013
Canada	3.2	2.5 (2.1)	2.4 (1.9)	2.4 (2.9)
United States	3.0	1.7 (1.7)	2.3 (1.7)	2.5 (3.2)
Eurozone	1.9	1.5 (1.5)	-0.4 (0.2)	0.9 (1.5)
China	10.4	9.2 (9.1)	8.2 (8.5)	8.5 (8.7)
World	5.3	3.8 (3.7)	3.2 (3.1)	3.5 (3.7)

*Figures in brackets are from the Bennett Jones Fall 2011 Economic Outlook.

Among the factors that will continue to weigh down on the growth outlook for the U.S. is an overhang of unoccupied dwellings and homes in the foreclosure pipeline. This is likely to restrain a rebound in residential construction until late 2013. Sluggish house prices continue to limit growth in household net worth and consumption spending. As well, projected subdued growth in the rest of the world, particularly in Europe, and a possible appreciation of the U.S. dollar against the euro, should European prospects deteriorate further, would hold back export growth.

The biggest potential headwind, and risk to the U.S. outlook, however, comes from a marked tightening of fiscal policy, especially in 2013. Indeed, stimulus-related policies are scheduled to wind down by the end of 2012, while additional fiscal consolidation of 1.5 percent of GDP (including automatic spending cuts under spending caps put in place last year) is in store for 2013. Fiscal tightening could climb to four percent of GDP in 2013 if temporary social security tax cuts and income tax cuts passed by the Bush administration are allowed to expire. Our U.S. growth projection of 2.5 percent for 2013 is consistent with a fiscal policy-induced reduction of real GDP of about two percent and a positive private sector contribution to growth of about 4.5 percent. Should the fiscal drag reach negative-four percent instead, the real economy would be plunged into a recession that no amount of monetary stimulus could avoid. We expect that sometime after November some political agreement will be reached to prevent going over the fiscal cliff but there could be temporary financial turbulence, loss of confidence and great uncertainty until the lame duck Congress finds a way to step back from the edge.

Growth in China and several other EMEs is expected to moderate in the next two years. It is worth keeping in mind, however, that some slowing may be desirable to contain inflationary pressures. In China, a very high investment rate should decline, while growth in household consumption should pick up, supported in part by strong gains in real wages. The Chinese government is targeting annual growth of 7.5 percent this year and seven percent in the current five-year plan period. This would require slower investment growth than in the past. We believe that GDP growth will be kept at over eight percent over the next two years, noting that Chinese authorities have considerable policy room to maintain growth at such level.

Aggregate demand in EMEs is expected to remain robust, though somewhat slower, and is likely to keep commodity prices close to current elevated levels. Some industrial commodity prices may strengthen late in 2012 as global growth picks up. International oil prices may experience spikes due to politically-induced supply disruptions as spare oil capacity globally will likely remain fairly tight. But with global growth below four percent over the next two years there will be little sustained upward pressure on industrial and energy commodity prices.

Exceptionally low policy interest rates are expected to persist over the next two years in most advanced countries and could even ease further in the eurozone. As a result, rates should stay at their lower bound much longer than was expected 18 months or even one year ago. In emerging economies, rates could ease somewhat in response to slower growth, especially if agricultural prices do not fuel inflationary pressures.

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Output expansion in Canada in 2011 turned out stronger than expected, mainly because of more resilient household spending. Strong employment growth over the first four months of 2012 suggests that these trends in output growth and household spending are likely to continue in the first half of this year. On the other hand, the Canadian dollar has strengthened somewhat since last November, and Canadian producers have not benefitted from the rise in international oil prices as the discounts of both the U.S. WTI off Brent *and* of Western Canadian oil prices off the WTI have been unusually large this year. These exceptional discounts should wind down over the medium term, provided proposed pipeline projects in the U.S. come on-stream in coming years. Meanwhile, they will hold back potential gains in Canadian terms of trade.

Looking forward, Canadian growth is expected to proceed at a 2.4 percent annual pace in the next two years, a pace that is barely slower than in 2011. The economy should be operating at capacity by around mid-year 2013. Virtually all of the projected growth originates from final domestic spending by businesses and households, despite the fact that household spending may be somewhat constrained by the high ratio of household debt to income. Consistent with the new budgets this year, government spending on goods and services will make no contribution to growth. Real net exports will make only a small contribution to growth as world trade expansion is likely to slow in 2012 (see Trade section below). In addition, many Canadian industries (especially in the manufacturing sector) have a serious problem of cost competitiveness and these may lose market share both at home and abroad.

Under this scenario, we expect only a very gradual rise in interest rates, a modest increase in employment, and stable or slightly declining housing prices. Therefore, the risk of significant deleveraging by Canadian households in 2012 and 2013 appears to be low.

Canadian policy rates are likely to remain low through 2012 and 2013, although at some point over this period they may well start increasing at a measured pace as excess capacity in the Canadian economy is absorbed, as is projected by the Bank of Canada. Although a widening of the interest rate differential in favour of Canada would then tend to push the Canadian dollar higher, much volatility of the currency around parity is to be expected in response to international developments. Should there be a shock to the Canadian economy, on the downside or the upside, our inflation-targeting monetary policy would adjust as would automatically some elements of government revenues and expenditures.

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Some Implications for Canadian Business

Canadian firms have run a substantial financial surplus in the post-recession years and as a result now have healthy balance sheets. Their cost competitiveness, however, has deteriorated markedly as a result of a substantial appreciation of the Canadian dollar. Only in 2011 did faster productivity growth in Canada than in the U.S. provide a slight offset to the appreciation.

Strong balance sheets, combined with low financing rates and a strong Canadian dollar, provide favourable conditions for the acquisition of new capital goods and related investment in efficiency improvement and product innovation. On the other hand, businesses will have to cope with a Canadian dollar likely to remain near parity, accelerating labour costs (particularly in Western Canada), and more severe shortages of some skills across the country, especially in construction and engineering. Trade barriers are not expected to constitute an obstacle to business growth.

Trade Issues

Strong global trade was an important component of the rapid recovery in global GDP in 2010. Trade growth slowed to 5.0 percent in 2011 but continued to expand faster than global GDP. Slow global GDP growth in 2012 implies that trade is likely to expand by only 3.7 percent.[1] And despite the global economic crisis, bilateral efforts to negotiate freer trade arrangements continue. Nevertheless, Pascal Lamy, WTO Director-General, commented that "recent worrying slippages in the form of trade restrictive measures have been registered", and no progress has been made in the Doha round of negotiations.

With respect to the Doha round of trade negotiations, the prospects are not good. The BRICS countries – Brazil, Russia, India, China, and South Africa – issued a statement emphasizing that completing the Doha Round "would be a significant step" in strengthening the multilateral trading system. However, there is no apparent belief in the U.S. Administration that any kind of breakthrough is possible. Indeed, Michael Punke, the U.S. WTO ambassador who represented the U.S. at the Puerto Vallarta G20 trade ministers meeting, put out a statement at the conclusion of the meeting in which he made no mention at all of the Doha Round. It is not expected that either the G8 meeting or the June G20 meeting in Mexico will put much emphasis on trade although there will be a reiteration, and perhaps a useful strengthening, of the commitment to avoid protectionism.

While the Doha Round may be dead, some important bilateral and regional (TPP) negotiations continue. In Canada the Harper government continues to put major emphasis on its ambitious trade negotiations agenda as a cornerstone of its Jobs and Growth Strategy. In the Budget plan tabled in the House of Commons March 29, Finance Minister Flaherty stated that the "Economic Action Plan 2012 proposes to intensify Canada's pursuit of new and deeper trading relationships". The list of initiatives begins with Canada-U.S. Border and Regulatory Action Plans, continues with a pledge to deeper Canada-China ties, and then moves on to free trade negotiations with the EU and India, before listing numerous trade and other economic initiatives in virtually every area of the world. No Canadian government has ever had such an ambitious international business agenda, nor given it such pride of place in the government's most visible documents – the Speech from the Throne and the Budget.

The negotiations with the EU are now entering their final phase and we will probably learn before the end of the year whether the government will be able to deliver an actual agreement with the EU. If the government can bring this agreement home it will give a major boost to their trade ambitions. On the other hand, failure, or indefinite delay, would call into question the likelihood of the government achieving its trade objectives.

The government is also putting major diplomatic effort into following up on Prime Minister Harper's decision to seek to join the TransPacific Partnership Negotiations (TPP). However, despite engagement at the highest levels by Mr. Harper and his trade minister the government has so far failed to convince the U.S. to agree to Canadian participation. The main reason seems to be that negotiations among the current negotiating partners are so advanced that the U.S. would prefer to finish the negotiations before letting additional countries (*i.e.*, Canada, Mexico and Japan) into the negotiations, lest they slow down the process.

The Bennett Jones Spring 2012 Economic Outlook, takes into account all information available up to and including May 11, 2012.

1. Taken from April 12, 2012, WTO press release - http://www.wto.org/english/news_e/pres12_e/pr658_e.htm

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