Bennett Jones

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Economic Outlook

Spring 2018

Bennett Jones

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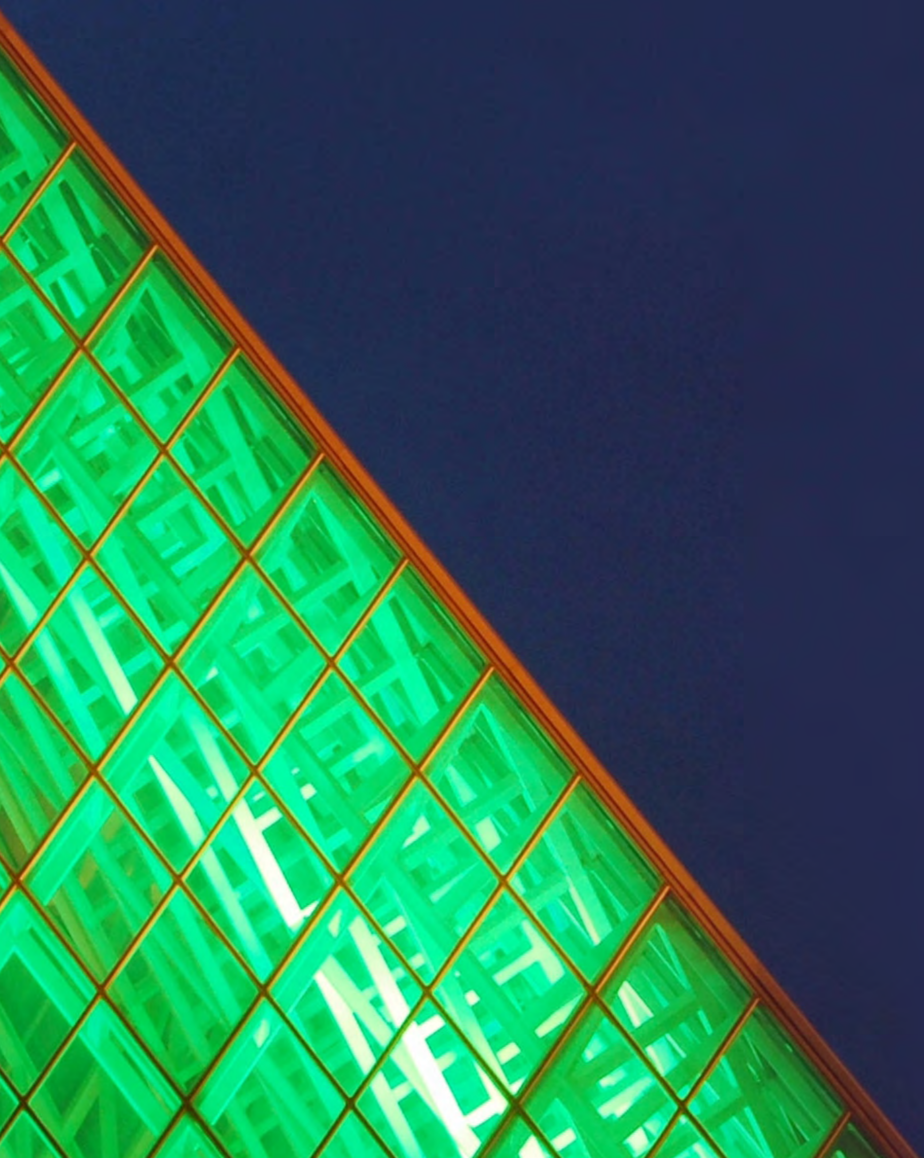
Section I: Global Growth to 2020

The outlook for global growth in 2018 and 2019 is now considerably stronger than forecasters anticipated it would be a year ago. Advanced economies are now expected to grow at rates well in excess of potential in both years, eliminating remaining slack in the United States, Europe and Japan. This strong growth is underpinned by accommodative financial conditions, a stronger expansion in many emerging economies, and a large tax and expenditure stimulus in the United States. At the same time, central banks in the advanced economies continue to be cautious in raising interest rates and have indicated their willingness to accommodate above-trend growth as wage and price inflation continues to be benign. Credit conditions will continue to be favourable for continued growth through the end of 2019 even as central banks cautiously raise interest rates. But continued expansion of credit brings with it the collateral risk of rising aggregate debt (household, business and government) that could seriously threaten stability and growth down the road. Thus, both Canadian business and government should keep in mind that the buoyant prospects for global growth over the next two years, growth sustained by accommodative monetary and fiscal policies in the advanced economies, are associated with an increasing risk of a major correction in the 2020s.



Recent Developments

In the advanced economies, real GDP has grown strongly since the end of 2016. The swifter momentum began in the Euro area in the last quarter of 2016, in Japan in the first quarter of 2017 and in the United States in the second quarter of 2017. Above-trend growth has been propelled by increased investment and stronger consumer spending. These have been supported by high levels of business and consumer sentiment and accommodative financial conditions. Moreover, stronger economic activity and higher capacity utilization have had an "accelerator" effect on non-residential business investment. The rapid expansion paused in the first quarter of 2018. Whereas real GDP actually declined in Japan, it still grew significantly faster than potential in the United States and slightly above potential in the Euro area. In both the United States and the Euro area, much of the slowdown in the first quarter was attributed to one-off factors, including unseasonably harsh weather.

Despite accelerating growth and improving labour markets over the last 18 months, inflation in the advanced economies has remained rather subdued. Core inflation in 2018-Q1 was about 1.0% in the Euro area and around 0.0% in Japan, much below target. In the United States, core inflation[1] climbed from about 1.5% in 2017-Q4 to 1.8% in April, close to target. The pace of annual wage gains in the United States, however, continued to be moderate in the first five months of 2018. While the European Central Bank and the Bank of Japan have held their policy interest rates at emergency low levels, the Federal Reserve has continued the process of interest rate normalization as it lifted the target federal funds rate by another quarter percent in December 2017 and again in March 2018, to 1.75% (upper limit).

After a sharp decline from mid-2014 through early 2016, commodity prices staged a fairly steady recovery through to April 2018, which brought them to about three quarters of the average level they reached from early 2012 to mid-2014. West Texas Intermediate (WTI) oil prices, in particular, steadily firmed from a trough of US$45 a barrel in June 2017 to just over US$70 a barrel in May 2018 reflecting stronger global demand and cuts in the supply of the Organization of the Petroleum Exporting Countries (OPEC) oil, both of which reduced ample inventories to below-average levels in spite of increased shale oil production in the United States. The U.S. withdrawal from the nuclear deal with Iran and the economic and political crises in Venezuela also put pressure on oil prices in May. The firming of commodity prices has contributed to improved growth in resource dependent emerging market economies such as Brazil and Russia.

On a trade-weighted basis the U.S. dollar (broad index) has been fairly volatile in the last 18 months. In the last week of May it was 9.0% above its average of the previous 20 years, reflecting in part a 2.0% appreciation during the month.

Growth in China has remained remarkably strong and stable over the last five calendar quarters at just above the authorities' target growth rate of 6.5%. While Chinese authorities have taken some steps to moderate house price increases, credit conditions have remained expansionary. Continued strong growth of domestic demand in China and the advanced economies has contributed to synchronized growth in most of the world's economies for the first sustained period since the great financial crisis.

Section I: Global Growth to 2020

Global Economic Outlook

The synchronized global expansion of 2017 is projected to continue in 2018 and well into 2019. Global growth is expected by the International Monetary Fund (IMF) to come in at about 3.9% in both 2018 and 2019 well above global potential growth of about 3.5%. By 2020, global growth is expected by most forecasters, including the IMF, to slow to about potential.

The main factors contributing to this buoyant short-term outlook are as follows:

- Negative shock of falling commodity prices in 2014–2016 has passed.
- Fiscal policy is less restrictive in most countries and very expansionary in the United States (see next page).
- While central banks will continue to raise policy interest rates, they have all indicated that increases will be gradual and that they are willing to see some period of modestly above-target inflation.
- Business investment growth is expected to continue at a robust pace, buoyed by solid profits and high levels of business confidence and capacity utilization in many countries.
- Household consumption in the advanced economics and China remains robust. High levels of consumer confidence and a strong labour market prevail in many countries.
- WTI oil price is now expected to be above US$65 in 2018 and 2019 on the strength of global demand, but production will probably expand enough (along with some further inventory drawdown) to keep WTI below US$75 on an average annual basis. However, slower growth of the global economy in 2020 will reduce oil demand growth and should prompt a retreat of the price of WTI to around US$60 to US$65. Geopolitical developments, notably regarding Iran, create upside risks to oil prices in the short term and no doubt will contribute to considerable volatility in oil markets.
- Despite protectionist actions by the United States, several observers including the IMF expect international trade to expand somewhat faster than domestic demand, thus enhancing global growth as international trade did in most years prior to the great financial crisis. The projected increase in trade intensity would partly reflect the buoyancy of investment in machinery and equipment, which has a relatively high import content.

In the short run we expect positive factors to contribute to above-trend global growth despite the immediate geopolitical uncertainties. While there may be significant downside risks to growth in the early 2020s as we outline in the “Risks” section, we believe our base-case projection of prospects for global growth (Table 1) provides a sound planning basis for Canadian business and governments.

Base-Case Projection

Our base-case projection for global growth of 3.8% in 2018 and 2019 is considerably higher than the 3.5% we projected last fall. This upgrade mostly arises from much stronger growth in the United States as we explain below. Growth in the Euro area is also expected to be a little stronger while growth in China remains as strong as projected last fall.

Table 1

SHORT-TERM PROSPECTS FOR OUTPUT GROWTH (%)*

	World Output Share (%)	2017	2018	2019	2020
Canada	1.4	3.0	2.1(2.1)	2.1(1.6)	1.8
United States	15.3	2.3	2.9(2.3)	2.6(2.0)	2.0
Euro Area	12.0	2.5	2.2(1.9)	2.0(1.6)	1.7
Japan	4.3	1.7	1.2(1.0)	1.2(0.8)	0.3
Advanced Economies[1]	33.0	2.3	2.4(2.0)	2.1(1.7)	1.7
China	18.2	6.9	6.6 (6.5)	6.4(6.3)	6.3
Rest of World	48.8	3.4	3.7(3.6)	3.9(3.6)	3.7
World	100	3.7	3.8(3.5)	3.8(3.4)	3.5

* Figures in brackets are from the *Bennett Jones Fall 2017 Economic Outlook*.

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

Before tax cuts and spending legislation was passed around the end of 2017, we projected in our *Bennett Jones Fall 2017 Economic Outlook* an above-trend growth rate for the United States of slightly more than 2.0% for 2018 and 2019. This above-trend performance was predicated on elevated consumer confidence, strong labour market, accommodative financial conditions, and strengthening investment. All these factors still underpin the above-trend U.S. growth rates currently projected in 2018 and 2019. In addition, the U.S. tax and spending policy changes that were introduced around year-end are expected to have a far larger effect in the short-term than we anticipated last fall. Moreover, we observe that consumer confidence and business confidence in the United States are nearing historical peaks and that proposed relaxation of restrictive financial regulation will contribute to easier credit conditions. We would expect domestic spending to show more strength than otherwise because of these two factors.

Faced with prospects for stronger growth and hence greater inflationary pressures, the Federal Reserve is expected to raise its policy rate to a higher level (3.0% to 3.5%) by the end of 2019 than we anticipated last year at this time. This additional withdrawal of monetary stimulus, along with a likely positive effect on the U.S. dollar exchange rate, would offset some of the stimulus from tax cuts and spending increases by 2019 and 2020.[2]

The combination of all the above factors has caused us to increase our projections of U.S. growth rates by 0.6 percentage points to 2.9% for 2018 and 0.6 percentage points to 2.6% for 2019. The stimulative impact fades to 0.2 percentage points by 2020. In the absence of a geopolitical shock or unexpected burst of inflation, growth in 2020 is projected to be 2.0%, a rate consistent with a somewhat stronger potential growth than before. While we are not quite as bullish as the IMF on U.S. growth in the short run, we have substantially increased our projected growth rate as illustrated in Table 2 below.

Table 2

U.S. REAL GDP GROWTH (%)	2018	2019	2020
1. ***Bennett Jones Fall 2017 Economic Outlook*** **projection before policy changes**	2.1	1.9	1.8
2. **Plus effect of U.S. Tax Cuts and Jobs Act**	0.3	0.3	0.2
3. **Plus impact of government spending increases**	0.3	0.4	0.0
4. **Plus improved sentiment and less restrictive regulation—trade uncertainty**	0.2	0.1	0.1
5. **Less impact of additional increases in interest rates**		-0.1	-0.1
6. ***Bennett Jones Spring 2018 Economic Outlook*** **projection**	2.9	2.6	2.0

The first important fiscal change in the United States enacted late last year is the Tax Cut and Jobs Act (TCJA) (line 2, Table 2). Many studies produced estimates of the macroeconomic impact of the TCJA over the next decade. Our judgment is that the estimates produced by the Congressional Budget Office (CBO) in April[3] provide the most realistic picture of the macroeconomic impact of the TCJA over the coming decade. Based on these estimates, we expect the TCJA to boost growth by 0.3 percentage points each in 2018 and 2019 and by 0.2 percentage points in 2020. For a more detailed description of TCJA and analysis of its macroeconomic effects, please see Annex 1 at the end of this section.

The second important fiscal change in the United States arises from spending increases in the Bipartisan Budget Act, 2018 (BBA) and the Consolidated Appropriations Act, 2018 (CCA). These acts increase federal spending authority in 2018 and 2019 by US$150 billion (0.7% of GDP) each year. Based on CBO estimates of their impact on the level of real GDP, we expect these measures to boost growth by 0.3 percentage points in 2018 and 0.4 percentage points in 2019 (line 3). We assume that the higher level of federal spending will be maintained in 2020 and therefore will have no additional effect on growth in that year.

The Trump administration has also introduced regulatory changes which have favoured increased business investment[4] and will effectively ease credit conditions going forward (line 4). At the same time it has created much uncertainty about its future protectionist trade actions and the retaliatory response of trading partners. While it is very difficult to estimate the total impact that these three changes will have on growth, we judge that a net improvement in business sentiment will lead to higher investment and contribute about 0.1 percentage points of additional annual growth over the next three years.

As a result of all these changes, we and most analysts expect the Federal Reserve to raise its policy interest rate somewhat faster than anticipated before. Indeed, the Federal Reserve revised upwards the projection of its policy rate over 2018-20 at its March 2018 meeting. We project the additional rise in interest rates and its possible boost to the U.S. dollar exchange rate to subtract 0.1 percentage points from growth in 2019 and 2020 (line 5). Our projection of the U.S. policy rate is close to that of the Federal Reserve: we anticipate that the Federal Funds rate (upper limit) will be raised to 2.25 to 2.5% by the end of 2018 and to 3.0% to 3.5% by the end of 2019 or early 2020. The Federal Reserve projects that a rate only slightly above their 2.9% estimate of the "neutral rate" will be necessary to maintain inflation roughly at 2.0% over the next couple of years. Should much stronger excess demand emerge— as the IMF thinks might be the case—then the Federal Reserve might have to move rates up faster and further. However, since the Federal Reserve's projected growth is closer to our projection than to the IMF projection, we think that Canadian businesses and governments should do their planning based on an expected increase of the Federal funds rate to about 3.25% by early 2020 and on the basis that the yield on 10-year U.S. treasury bonds will reach about 3.5%.

We expect part of the slowdown in the Euro area in 2018-Q1 to be the result of one-off factors and project growth there to be above trend in the short term. As excess capacity diminishes and monetary policy gradually becomes less accommodative the pace of growth will slow from 2.5% in 2017 to 2.2% in 2018, 2.0% in 2019 and 1.7% in 2020 compared with a trend growth rate of close to 1.5%. This strong performance will be supported by high confidence levels, accommodative financial conditions, and robust growth in world trade and activity. The expansionary effects of fiscal policy changes in the United States will contribute to the latter. On the other hand, the appreciation of the Euro against a basket of currencies in the last year is expected to moderate net export growth for a little while. This being said, the Euro-U.S. dollar exchange rate started depreciating in mid-April and will probably continue to do so on average in the rest of 2018 and most of 2019 as the United States will likely experience widening positive differentials in economic growth and interest rates relative to the Euro area over this period. As with regards to fiscal policy in the Euro area, it is projected to be neutral to slightly restrictive over 2018-20.

Despite weakness in the first quarter this year, growth in Japan is set to be above trend in the short term as robust consumer confidence, strong profits and rapid global growth support significant expansion of domestic demand and exports. Growth in 2018 and 2019 is now projected to be a bit stronger than last fall. A planned hike in the value-added tax in 2019 will slow growth significantly in 2020.

China is expected to continue to pursue policies that will allow real GDP to grow at rates consistent with its earlier 6.5% target but allowing for a gradual slowing in the short term in order to pursue "quality instead of speed" in keeping with the priority given at the 19th Congress on economic transformation (including rebalancing) and sustainable growth. We assume that there will be no major disruption of trade with the United States (see Section II on trade) and expect that the Chinese authorities will keep the yuan exchange rate close to its recent level of 6.3 yuan per U.S. dollar in the short term. The IMF expects nonfinancial debt to rise further as a share of GDP, increasing risks for financial stability and growth in the medium term.

Risk to the Short-Term Outlook

Aside from the heightened geopolitical risks of turmoil involving Iran and the Middle East or more overt conflict between Russia and the west, the main negative economic risk to the strong projected global growth of 3.8% in 2018 and in 2019 relates to protectionist trade actions by the United States and potential retaliatory actions by others. One reputable analyst estimates that in the worst case “a global trade war, though still unlikely, would administer a negative shock to world GDP of perhaps 1 to 3 percentage points in the next few years.”[5] Trade risk is discussed in detail in the next section of this outlook.

We think that over the next two years the risks to global growth arising from major changes in projected monetary and fiscal policies of governments in the United States, Europe or China are fairly limited. More specifically, as we consider that a strong burst of U.S. inflation has a low probability of occurring in the short term, we think the risk of interest rates being significantly higher than projected is low. While the stimulative impact of the recent fiscal policy changes in the United States may turn out to be modestly larger or smaller than currently projected, the risk of a significantly different policy impact on global growth from our current projection is also low.

Finally, we consider that the upside risk that global growth be stronger than we project in the short term is more important than the downside risk that would arise if the unexpectedly subdued growth observed in 2018-Q1 in advanced economies were indicative of a return to lower-trend growth. The risk of higher growth than projected (especially over the next 12 months) arises from the high level of positive business sentiment in the United States, Japan and Europe, which may prompt stronger investment than anticipated. In turn, stronger investment may boost potential output and allow significantly faster demand growth than projected without generating greater inflationary pressure. In that case, global growth could well reach 4.0% in both 2018 and 2019 and could exceed 3.5% in 2020.

Taking all of the above risks into consideration, we believe Canadian businesses and governments should do their planning based on our projection of strong global growth in the order of 3.8% this year and next, slowing to 3.5% in 2020. They should plan for the interest rate on U.S. 10 year treasuries to rise to a peak of 3.5% over this period and for commodity prices to remain in a reasonably favourable range.

Medium-Term Risks

Except for the ever present geopolitical risks and the possibility of a significant disruption to international trade, the risk of a sharp economic slowdown over the next two years is thus fairly low. However, the medium-term risk of an economic disruption is much greater. Favourable credit conditions, optimistic consumer and business sentiment and increased government borrowing by the world’s major governments in 2018 and 2019 will likely add substantially to the current high global debt level by the end of 2020. This high and rising level of debt renders the global economy increasingly more vulnerable to an abrupt correction and makes the global financial system much more fragile. The same sort of imbalances we observed in 2005 and 2006 seems to be emerging again. Leverage and risks are building. While the financial sector has stronger buffers than 10 years ago, consumers, businesses and governments in most large economies are leaving themselves less able to absorb economic shocks. Fiscal authorities will have less room to provide stimulus in the next downturn.

With policy interest rates already low, central banks will have less room to provide conventional monetary stimulus to stabilize a faltering economy. Moreover, the projected substantial widening of both budget and current account deficits in the United States raises the risk of higher U.S. real interest rates (to attract capital) and weaker U.S. growth in the medium term, with negative spillovers in the rest of the world, especially emerging economies.

Canadian governments, businesses and individuals should take advantage of the current outlook for strong global growth and still favourable interest rates by investing in productive infrastructure, productivity enhancing research machinery and equipment, and skills upgrading (see Section IV: Taxes, Regulation and Competitiveness). Increasing borrowing to pay for expanded current services, to fund buy backs and higher dividends, or to enjoy greater consumption of goods or services today would make Canada vulnerable to a global economic slowdown, the risk of which increases in the 2020s.

Annex 1: Impact of the U.S. Tax Cut and Jobs Act

This annex is about the macroeconomic impact of the TCJA which took effect on January 1, 2018, i.e., the impact on economic growth and potential economic growth. We summarize expert analysis of the aggregate implications of the TCJA for investment, labour supply and government deficit but not the impact on U.S. businesses and their Canadian subsidiaries at a firm or industry level. We first describe the major changes to the tax system and their theoretical effects, and then provide estimates of these effects essentially based on the detailed analysis done by the U.S. CBO.

The TCJA includes many changes to the tax system which affect both individuals and businesses. Among the changes that are expected to have a bearing on the U.S. macroeconomy, the following are worth noting:

- a permanent cut in the corporate tax rate from 35.0% to 21.0%;
- rate of bonus depreciation raised to 100.0% in 2018, extended for five years through 2022, and then phased out by the end of 2026; depreciation made less generous for R&D and for software development beginning in 2022;
- repeals of or limits on deductions for a number of business expenses, including tighter limits on interest deductibility;
- elimination of the taxation of most foreign corporate income of U.S. corporate shareholders; one-time transition tax on untaxed profits; base erosion measures and effectively a minimum tax on some of the foreign operations of U.S. corporations;
- lowering statutory marginal tax rates for income of individuals, while changing some of the income levels associated with each bracket; eliminating personal exemptions while increasing the standard deduction and the maximum amount of child tax credit; all these changes expire by 2025; and
- permanent change in the measure of inflation for adjusting tax system parameters to a chained Consumer Price Index (CPI) measure which will accelerate bracket creep and hence increase individual tax revenues over time.

The size and time profile of the impact of these measures on U.S. GDP will be the outcome of several factors:

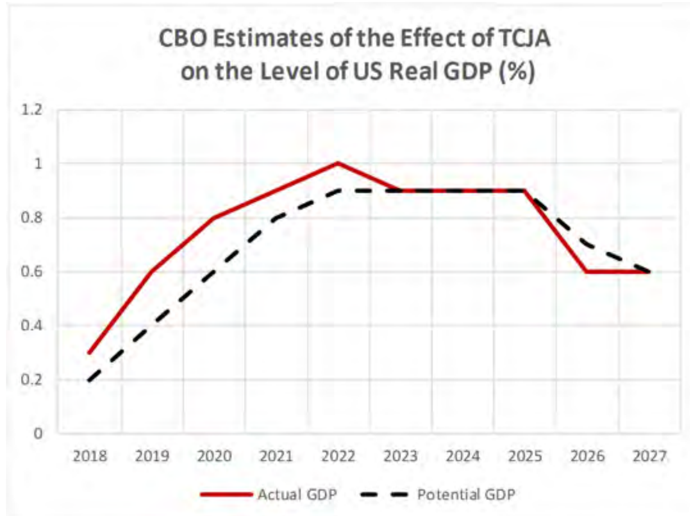
- how much of the reduction in taxes paid by individuals and businesses is ultimately spent on consumption, housing, investment and imports, account taken of the fact that businesses will channel part of their tax savings into share buybacks and dividend payments and that individuals will save rather than spend part of the tax savings and the increased receipts from businesses. This static, budgetary effect raises GDP and, to a lesser extent, potential GDP.[6] It is worth noting that in dollar terms much of the tax savings will accrue to individuals with higher incomes than average and that, as a result, the growth impact of the tax cuts will be attenuated because higher-income individuals have a higher marginal propensity to save than average;
- whether and when U.S.-based firms, incurring one-time tax on earnings offshore, will in fact patriate the earnings (or leave them offshore) and then invest in the United States or distribute the earnings to shareholders;
- how the cut in effective marginal tax rates for individuals stimulates increased labour supply and how the decrease in the after-tax user cost of capital resulting from lower statutory tax rates and larger bonus depreciation brings additional investment,[7] including net direct investment from abroad. This two-pronged supply-side effect raises GDP and potential GDP;
- by how much TCJA boosts GDP relative to potential GDP and hence inflationary pressures in the economy, thereby pushing up interest rates and strengthening the exchange rate, with negative effects on GDP;
- how the government, households and firms react to the projected expansion of the public deficit and debt resulting from the tax cuts; if the government eventually undertakes restrictive fiscal measures or if individuals and firms raise their saving rate to cope with an anticipated rise in their future tax liabilities, the negative effect on aggregate demand would offset part of the positive effects of the original tax cuts; and
- how much the debt-to-GDP ratio rises as a result of the fiscal changes and how much this raises long-term interest rates with negative effects on aggregate demand.

Whether the currently temporary provisions of the TCJA will be eventually extended or made permanent is uncertain. Ceteris paribus, this would increase the positive impact on GDP beyond 2025, but at the same time raise the debt-to-GDP ratio even further. In a context of large deficits, the case for making the temporary provisions permanent would exist only if the positive effect of tax cuts on potential GDP were large. Only the next several years will tell whether, in contrast with current expectations, this is a plausible outcome. If the effect is not large enough and yet the measures were to be made permanent anyway, then most likely financial market pressure would lead to fiscal correction measures to contain rising long-term interest rates and/or the private sector would start increasing its precautionary saving. In such circumstances, the net positive effect of the tax cut extension would be considerably diluted, if not completely offset over time.

Methodology and assumptions have a big impact on the estimates of the effects of TCJA. The CBO projects that TCJA would expand the federal deficit by a cumulative $0.7 trillion over 2018-20 and $1.8 trillion over 2018-27, taking into account higher debt-service costs and the positive macroeconomic feedback effects on taxable incomes of individuals and businesses.[8] By comparison, the corresponding deficit impacts estimated by the bipartisan Joint Committee on Taxation are $0.6 trillion over 2018-20 and $1.1 trillion over 2018-27.[9] Changes to taxes on individuals constitute the largest source of revenue loss in the short term while changes to taxes on foreign corporate income provide a partial offset by generating additional revenue.

The estimated impact of TCJA on the level of GDP varies considerably across studies, even for the short term. A sample of eight projections show real GDP higher by between 0.3% and 0.9% over 2018-20 and by between -0.1% and 2.9% by 2027. The estimates of the CBO, which are based on sound methodology and reasonable assumptions and have been assembled with great attention to fiscal details, provide a solid basis for judging the impact of TCJA. They show the positive effect of TCJA on the level of real GDP rising from 0.3% in 2018 to a plateau of about 0.9% in 2021-25 before declining to 0.6% by 2027 following the expiration of individual tax cuts and the phasing out of bonus depreciation. In the short term, TCJA would provide a boost to real GDP growth of 0.3 percentage points in 2018, 0.3 percentage points in 2019 and 0.2 percentage points in 2020. These are the estimates on which we have based our projections of U.S. growth.

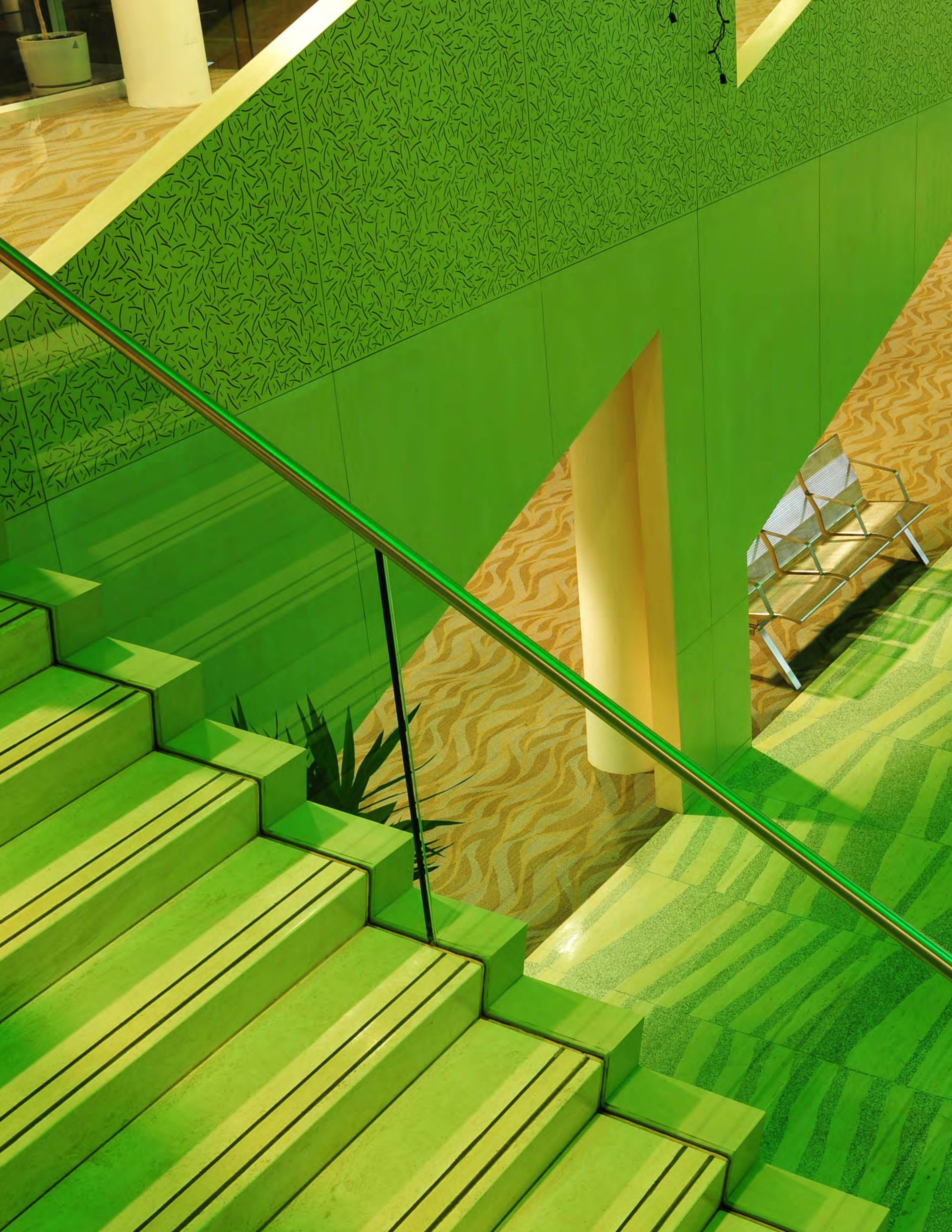
Chart 1



Sources: CBO, *The Budget and Economic Outlook: 2018-2028*, April 2018.

The impact on potential GDP would be similar to that on GDP itself over the period, albeit smaller until 2022. The increase in potential GDP stems in part from a rise in labour force participation and hours worked in response to a fall in the average effective marginal tax rate for individuals of about 2.1 percentage points through 2025 and zero afterwards. It also stems from an increase in capital intensity and innovation as investment responds positively to the cut in the effective marginal federal tax rate on capital income. Such a cut is estimated by the CBO to be 1.8 percentage points in 2018, widening to 3.4 percentage points in 2021 before narrowing to 1.5 percentage points by 2027. Investment would also respond, but more modestly, to the increase in economic activity and rise in interest rates induced by TCJA.

As a result of a faster increase in GDP than potential GDP, a larger excess demand in the U.S. economy would persist until 2022, raising inflation and interest rates temporarily and possibly pushing up the external value of the U.S. dollar. The consequent crowding out of U.S. private spending would intensify until 2022 before receding almost completely by 2027.



Section II:
International Trade

As noted in the previous chapter the main negative economic risk to strong projected global growth relates to potential protectionist trade actions by the United States and possible retaliatory actions by others. This chapter will assess how this negative scenario might unfold and what action might be taken to mitigate the risks. From a Canadian perspective the top concern is, not surprisingly, Trump's trade policy towards Canada led by the NAFTA renegotiations. However, President Trump's overall approach to trade with the world, and in particular, his stance at the World Trade Organization is also important in considering prospects for the Canadian economy. In fact, the Trump administration's approach to Canada can only be properly understood in this broader context. The chapter will also consider the implications for Canada of the fact that the conclusion of the NAFTA renegotiations has now most likely been kicked down the road until after the U.S. Congressional elections in November and the swearing in of a new Mexican president on December 1. This means continued uncertainty for Canadians and Mexicans on whether NAFTA will survive, and if so, under what terms. Through this uncertainty Trump and his trade representative Ambassador Lighthizer seem to be on the road to achieving one of their primary objectives—to discourage investment in Mexico and Canada in favour of the United States. The duties imposed June 1 on Canadian and Mexican steel and aluminum exports to the United States are an example of this uncertainty.

The trade policy of the Trump administration continues to push an aggressive America-first approach focused on ending American trade deficits and rebalancing trade agreements, preferably on a bilateral basis, so that they are more favourable to the United States. Not surprisingly, other countries are wary of engaging with the Americans on this basis. For some like Canada, Mexico and South Korea it has not been possible to avoid negotiations. But for others with whom the United States would like to negotiate new bilateral trade agreements there have been no takers to date. Trump has been trying hard to get Japan's Prime Minister Abe to start bilateral negotiations but the Japanese are resisting, suggesting instead that renewed American engagement in the Trans-Pacific Partnership (TPP), now the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), would be a better way to improve trade relations between Japan and the United States.

While the administration is charging off in many directions, the biggest challenge they face by far is China and, surprisingly, they are making this challenge even bigger by avoiding opportunities to work with allies who may share a common interest in seeking to negotiate better trade rules with China. This shows the extent of their belief that trade relations are a zero-sum game and that by working with others they reduce the potential benefits that would accrue if the United States goes it alone.

Essentially, U.S. trade policy has become transactional. The administration is engaged in negotiations with a number of countries but none of these are aimed at negotiating a trade agreement designed to provide open markets backed up by strong enforceable rules. Instead they are seeking to manage trade by getting other countries to restrain exports to the United States and apply various fixes that will advantage American interests. One example is the use of Section 232 national security investigations as a tool to control imports. This is the technique that the administration has selected to impose duties on Canadian steel and aluminum imports. Employing the national security argument when there is no strong case establishing a national security risk is a direct threat to the integrity of the international trade rules. The May 23 announcement that Commerce Secretary Wilbur Ross has initiated a Section 232 investigation into the national security implications of automobile imports is alarming. The situation is made worse by news reports suggesting that the administration is considering imposing a 25.0% duty on automobile imports following the investigation. Not surprisingly senior government officials in the EU, Japan, South Korea and China immediately raised concerns. In these unfortunate circumstances we see no alternative but for Canada to retaliate by applying duties on an equivalent amount of well-chosen American imports. Consequently we support the government's decision to do so. The EU and Mexico are on a similar course. If we do not retaliate we are effectively telling the Americans that they can hit us with impunity, and automobiles could well be the next target. We do not think that launching a WTO complaint is likely to lead to any positive resolution because it is almost certain that the United States would refuse to cooperate in a proceeding looking to rule on what are the essential security interest of the United States.

This administration is not interested in agreements under which businesses are free to compete because such agreements would not always guarantee that American businesses would win. No, they are seeking to replace the rules-based trading system with a power based system in which America will always come first.

Major Geographic Elements of U.S. Trade Policy

WTO

The WTO acts as the underpinning to the rules-based multilateral trading system. However, the Trump administration is frustrated by the constraints imposed on American behaviour by the WTO rules. They are annoyed that, as a result of successive rounds of negotiations, American tariffs are bound against increase at lower levels than those of most other countries including notably China. But probably the greatest frustration of the U.S. Trade Representative Robert Lighthizer is with the WTO dispute settlement system that has repeatedly found that aspects of American anti-dumping, countervailing duty and safeguard actions violate the WTO rules. This is a key reason why the United States is blocking new nominations to the WTO's Appellate Body (its appeals court). If the impasse continues for a couple of years, the Appellate Body will become inoperative and the process for settling disputes will grind to a halt. Trump has suggested that the United States might withdraw from the WTO. This is unlikely because it is extremely valuable to U.S. exporters. However, it is likely that the current administration will continue to try to undermine WTO rules except when they suit U.S. interests and will look to weaken the WTO dispute settlement system to ensure it does not have a significant restraining effect on U.S. policy. For Canada, that uses the WTO frequently to resolve disputes with the United States, weakening the system of WTO adjudication would be a major problem.

China

In 21st century geopolitics, no relationship is more important than that between the United States and China. Both countries are aiming to be global leaders. Their rivalry and their different economic systems will be central to efforts to set global trade rules and for decades to come.

The current bilateral discussions on trade are part of the opening act of searching for a bilateral economic accommodation. U.S.-China discussions on trade are underway but it is unlikely that we will see any quick progress. The ultimatum that senior U.S. cabinet officers took to Beijing in the first week of May was clearly not something that any reasonable person would think the Chinese would be prepared to accept. The title of the four-page document[10] gives a sense of what it is about—*Balancing the Trade Relationship between the United States of America and the People's Republic of China*. Assertions by Trump and his commerce secretary that a trade war would be easy to win do little to inspire confidence that these negotiations are being well managed in Washington. So far, the Trump administration's approach has been more bluster than a clear plan of how to build a durable relationship with China.

On the other side of the table, the Chinese continue to pursue the approach outlined by President Xi in Davos in January 2017 and reinforced at the 19th Congress of the Chinese Communist Party last fall. Modernizing the economy and opening up were key elements of that vision.[11] There is a worrisome contrast between the United States turning inward and scrapping with its allies over trade balances, and China pursuing visionary policies such as the belt and road initiative, designed to extend Chinese influence abroad and establish it as a global player for this century.

Despite the current confusion, it remains our view that both sides will manage this dialogue over the coming months in a way that will prevent a major breakdown, although with Donald Trump there is always high risk of unpredictable behaviour.

NAFTA

In all likelihood Canadians will have to get used to living with a **less certain NAFTA** for at least another year. However, the prospect that President Trump might invoke the NAFTA withdrawal clause in NAFTA Article 2205 has receded somewhat. American business interests and their allies (including Canada and Mexico) have made progress in convincing congressmen and other political leaders that the NAFTA is beneficial to the United States.[12] Despite the fact that Ambassador Lighthizer has said that NAFTA countries are “nowhere close to a deal” there have been no ominous tweets from the president. That said, with a president as unpredictable as Donald Trump, nothing is certain. But announcing withdrawal would be costly to Republican unity and damaging to Republican prospects in the mid-term elections in November. It is increasingly clear that invoking Article 2205 would be the opening salvo in a domestic battle that would pit businesses and powerful congressional allies against the president.

While ministers from the three NAFTA countries have met repeatedly over the last weeks in an effort to move NAFTA negotiations to a successful conclusion, it may be that the Trump administration is not unhappy to see this period of uncertainty continue for many months to come. These negotiations are focusing on American proposals for “rebalancing” the agreement, modernizing NAFTA (bringing it into the digital age), and on resolving certain traditional irritants that resonate in Congress.

Most of the ministerial effort has focused on one major rebalancing issue, the automobile rules of origin. Considerable progress has been made in exploring ways of addressing American concerns. This issue is seen as a key issue by Ambassador Lighthizer and agreement here could facilitate progress on other issues. Trade in automotive parts and vehicles constitutes a very substantial share of North American trade in manufacturers and it is a sector in which Mexico has done very well since NAFTA came into force in 1994. Lighthizer has backed off initial insistence that there be a requirement that 50.0% of the content be American—an unprecedented notion in any free trade agreement (FTA). Other proposals still being examined could make automobile production in North American less competitive on a global scale. That would clearly be a bad outcome.

Progress has been a lot harder on other rebalancing elements which include:

- a proposed sunset clause by which the NAFTA would terminate every five years unless the countries agreed it should be extended;
- a weakening or elimination of the various NAFTA provisions regarding the settlement of disputes; and
- a revised government procurement chapter that would substantially reduce benefits for Canada and Mexico.

Progress has also been elusive on the irritants that include:

- access for dairy products to the Canadian market;
- differences in intellectual policy, including with respect to pharmaceutical patents and border controls on counterfeit goods; and
- differences in the de minimis level above which taxes are applied to imported products purchased online—$800 in the United States versus $20 in Canada.

Canada is seeking improvements to the system of temporary entry visas for business persons in the current NAFTA and on improvements to the government procurement provisions. Both objectives will be difficult to achieve.

Congress and the Administration

The Americans are having a lively internal discussion on the roles of Congress and the administration in concluding the NAFTA renegotiations and then securing the implementation of the result. The assumption had been that the result would be put to Congress as envisioned under the detailed procedural provisions of the congressionally approved Trade Promotion Authority (TPA). This would ultimately require approval of the revised agreement and necessary implementing legislation by a simple majority of both houses of Congress with no amendments allowed.

However, two other approaches have been floated recently. We do not think that either one is likely to fly but we mention them briefly because they have been the subject of repeated media reports.

The first is the “skinny NAFTA” idea. Under this scenario the agreement would be stripped of any provisions that would require U.S. legislation to implement thus allowing the administration to bypass Congress in implementing the result.

The second scenario would have the president invoke the NAFTA’s withdrawal clause at the same time he submits the new agreement to the Congress for approval. Strong opposition to this scenario is building in Congress and it is unlikely the administration will pursue it.

Timing Constraints

To be passed by the current Congress the negotiations would need to be completed in the coming days. It seems highly unlikely that the agreement can be finished in the coming month, so it is now clear that if agreement is reached it will be the new Congress elected in November that will vote on it.

The Mexican presidential and congressional elections will take place on July 1. The new president will not be sworn in until December 1. The American mid-term elections are on November 6 and the results could alter the balance of power in the House and perhaps the Senate.

These developments mean the negotiations will almost certainly stretch into 2019.

What is Needed for a NAFTA Agreement?

The ingredients of a useful update to NAFTA are already in reach. The big question is how wedded President Trump is to the rebalancing proposals his trade representative has advanced. With a good agreement on rules of origin, a substantial updating of NAFTA and some progress on traditional irritants, President Trump could credibly claim success. It would certainly be a better deal for the United States than the tweaking of the South Korea FTA that Trump hailed as a great achievement. This might not be enough for Ambassador Lighthizer but at some point the president may decide to make his own decision.

Japan and the The Comprehensive and Progressive Agreement for Trans-Pacific Partnership

When President Trump announced the United States was pulling out of the TPP, almost everyone assumed it was dead. Few foresaw that Japan would reverse decades of operating in the shadow of U.S. trade policy and take the lead in bringing to the finish line a slightly revised agreement among the remaining 11 original participants in the American-led TPP. Japan has been motivated by strategic considerations involving its relationship with the United States and China. Japan is leery of engaging with the Trump administration in a bilateral negotiation. Instead they are using their lucrative market as leverage to lure the Americans back into the CPTPP. American exporters are already complaining about how they will lose out to competitors from other CPTPP members once the agreement comes into effect but it is unlikely that President Trump will decide to come back to this agreement. The Japanese are also concerned that the United States is withdrawing from the Asia-Pacific region, leaving China to play a growing role in Japan's neighbourhood. In this context, the CPTPP assumes strategic importance by creating a strong rules-based trade agreement in the Asia-Pacific region that serves as a point of reference for CPTPP countries, including Canada, as they negotiate with China.

U.S.-EU Trade Relations

At the end of the Obama administration it seemed probable that the United States and the EU would be able to conclude their Transatlantic Trade and Investment Partnership negotiations and establish a wide ranging bilateral free trade agreement. The prospects for such a deal are now remote. Instead, this bilateral relationship is deteriorating with the United States imposing protectionist tariffs on EU steel and aluminum shipments to the United States, while in return the EU is deploying retaliatory tariffs against the United States and preparing to launch a WTO case against the American action. In addition, the American withdrawal from the Iran nuclear deal has further divided the United States and the EU.

The implications of the U.S. effort to use its vast financial powers to coerce its allies (and indeed the world) into supporting its Iranian sanctions are troubling. If the Americans persist, other countries may well decide to look for alternatives to a world trading system financed through American dollars.

A Final Comment on Trump's Trade Policy

President Trump came in to office promising the pursuit of a vigorous America-first trade policy which would involve moving away from multilateral agreements and negotiating bilateral agreements with key partners. Sixteen months into his administration the policy is certainly aggressively America-first but there is scant evidence that it is actually moving Americans ahead. Trump quickly moved to take the United States out of the TPP and initiated a series of domestic investigations that have now resulted in actual or impending restrictions on steel and aluminum imports (and perhaps soon on automobiles), various imports from China in response to alleged intellectual property violations, and safeguard actions on washing machines and solar panels. These measures are causing considerable friction with America's trading partners but do not seem to be moving the needle in terms of addressing foreign barriers. And importantly, no country has agreed to initiate negotiation of a bilateral free trade agreement with the United States.

The United States appears increasingly isolated as other countries continue to negotiate free trade agreements without the United States, creating a situation in which American exporters will increasingly find themselves in a least favoured nation situation, being the only major country whose exporters will not benefit from multiple free trade opportunities through a network of free trade agreements.

How long will it take for the concern among American exporters in the heartland to reverberate in Washington?

What Should Canada Do?

In our view, the Canadian government, with considerable support from opposition parties and provincial governments, is on the right course. Despite the imposition of tariffs on steel and aluminum by the United States, we recommend that the Government of Canada should:

1. respond forcefully to the American duties applied to Canadian exports of steel and aluminum (and any other new trade barriers) in order to make clear that there is a real cost to American economic interests of taking arbitrary and unjustified action against Canadian trade;

2. continue to accord top priority to a successful completion of NAFTA negotiations. The objective should be two-fold. Bring an end to the uncertainty about the rules governing Canadian trade with the United States and Mexico, but make sure that a revised NAFTA is a beneficial agreement for Canada;

3. continue to engage in and encourage advocacy work with American allies in Congress, in the business community, and in state and local governments. These efforts have been important in building support for NAFTA and Canada's approach inside the United States. The Canadian government should keep in mind that although the actual negotiations are with the Trump administration, the relationship with allies and stakeholders inside the United States may well be more significant in the longer term; and

4. while recognizing that there is no real substitute for Canada's trade relationship with the United States, continue with efforts to diversify Canada's international trade relationships. This would include (in order of priority) efforts to:

    a. ratify the CPTPP before the end of 2018 to ensure that Canadian exporters will benefit from a first-mover advantage when the agreement comes into force. Join with other CPTPP signatories to encourage other countries in the Pacific region to accede to the agreement;

    b. encourage investors to consider competitive opportunities in Canada resulting from Canada's duty-free access to the EU under Canada-European Union Comprehensive Economic and Trade Agreement and soon into the CPTPP member countries, including Japan. Investors in the United States will not have such tariff advantages;

    c. pursue efforts with China to initiate negotiations designed to lead to a high-quality rules-based free trade agreement;

    d. lay the groundwork for a FTA with the UK to become effective once the UK leaves the EU;

    e. develop ideas about how to revitalize the WTO in the years ahead and use it as a force for managing the challenges posed by globalization. Ensure that the WTO system remains strong particularly for resolving disputes. Consider taking a lead in working with other like-minded countries in pursuit of these objectives; and

    f. continue efforts to develop FTAs with other important countries including India, the Association of South East Asian Nations, and Mercosur.

Section III:
Canadian Outlook

Recent Developments

After climbing to above 4.0% during the first half of 2017, real GDP growth declined to 1.7% during the second half and to 1.3% in 2018-Q1. A number of factors temporarily slowed growth in the first quarter, including poor weather and the new mortgage stress test measures introduced in January, which depressed housing resales after boosting them in 2017-Q4. This temporary weakness in the first quarter would cut annual growth in 2018 by about 0.2 percentage points.

Core inflation has risen markedly since last fall, reaching about 2.0% from February to April, at the mid-point of Bank of Canada's target range for inflation. On a year-over-year basis, growth in wage rates, as estimated using Bank of Canada's "wage-common" measure, has picked up considerably in the first quarter, to 2.6%.[13] The Bank of Canada refrained from raising its policy interest rate in March, April and May, having last increased it in January, by 25 basis points, to 1.25%. The Canadian dollar has shown considerable volatility relative to the U.S. dollar since mid-December, appreciating markedly in January, weakening in February and subsequently hovering around 78 U.S. cents until the end of May.

Prospects to 2020

Canadian real GDP growth should rebound in the rest of 2018 to reach 2.1% for the year as a whole. It should maintain a similar pace in 2019 before slowing to its upwardly revised potential rate of 1.8% in 2020 (line 7, Table 3). What underpins this firmness is the positive effect of a robust global expansion, particularly in the United States, an expansionary fiscal policy in Canada concentrated in Ontario (line 4), accommodative financial conditions, and higher levels and growth rates of potential GDP (line 5), the latter allowing more demand growth without exacerbating inflationary pressures.[14] At the same time, uncertainty about the prospects for, and possible impact of, a renegotiated NAFTA and other U.S. trade actions, the loss of competitiveness to the United States arising from the TCJA and from a divergence in regulatory trends between the two countries (notably in energy), and constraints on Canadian transportation capacity should hamper growth in investment and exports (line 6).[15] The competitive challenges faced by Canadian businesses and the necessary policy response by governments are discussed in Section IV.

Table 3

CANADIAN REAL GDP GROWTH (%)

	2018	2019	2020
1. ***Bennett Jones Fall 2017 Economic Outlook*** **before fiscal policy changes**	2.0	1.6	1.6
2. **Stronger global growth**	0.2	0.3	0.1
3. **Starting point—weak 2018-Q1**	-0.2	0.0	0.0
4. **Federal and provincial fiscal policies**	0.2	0.2	0.0
5. **Effect of higher potential GDP**	0.1	0.2	0.2
6. **Trade and competitiveness issues**	-0.2	-0.2	-0.1
7. ***Bennett Jones Spring 2018 Economic Outlook***	2.1	2.1	1.8

The Bank of Canada projects CPI inflation to reach 2.3% in 2018, in part due to temporary factors, and to average 2.1% in 2019 and 2020. Notwithstanding the fact that inflation is already at the mid-point of the 1.0% to 3.0% target range, monetary authorities will likely move cautiously in raising the policy interest rate in the short term. In fact, Governor Poloz stated that he is quite prepared to tolerate inflation temporarily above the mid-point, presumably on the condition that inflation expectations remain firmly anchored at 2.0%. We expect the target overnight rate to rise to about 1.75% by the end of 2018 and to 2.5% to 3.0% by the end of 2019, the same as in our *Bennett Jones Fall 2017 Economic Outlook*; this despite significantly faster growth in 2019 and 2020 in this projection. This is made possible by higher levels of potential GDP than envisioned last fall (line 5).

Overall, the contributions of consumption and housing to growth diminish going forward in response to rising interest rates and some housing policy measures. The contribution of business fixed investment increases slightly in response to pressures on capacity and to expectations of a solid expansion of sales accompanying global growth. This contribution would be larger were it not for the assumed negative impacts of trade uncertainty and loss of competitiveness to the United States. Notwithstanding U.S. trade actions, the contribution of net exports to growth would increase significantly going forward as aggregate demand expands more rapidly in the United States than in Canada.

The 2018 budgets of the federal government and the governments of Ontario, Quebec and Alberta should have a moderate positive effect on Canadian growth in 2018 and 2019. The fiscal impulses from the budgets, as measured by changes in net borrowing[16] as a percentage of GDP, add up to 0.4%, 0.1% and -0.1% of Canada's GDP in 2018, 2019 and 2020 respectively (Table 4). As a first approximation and with a large margin of error, these impulses could add 0.2 percentage points to growth in both 2018 and 2019. Although it is not clear how the new government in Ontario will alter its existing fiscal plan, much of the impetus to growth from the current federal and provincial plans originates from Ontario in fiscal year 2018-19, when both budget deficit and investment in capital assets expand greatly.

Table 4

FISCAL IMPULSES FROM 2018 BUDGETS

($ Billions)	2017-18	2018-19	2019-20	2020-21
Federal				
Budget Balance	-19.4	-18.1	-17.5	-16.9
Infrastructure	5.5	7.0	9.3	9.6
Net Borrowing	24.9	25.1	26.8	26.5
Fiscal Impulse as % of CAD GDP		**0.0**	**0.1**	**0.0**
Ontario				
Budget Balance	0.6	-6.7	-6.6	-6.5
Investment in Capital Assets	10.7	14.2	15.7	15.8
Net Borrowing	10.1	20.9	22.3	22.3
Fiscal Impulse as % of CAD GDP		**0.6**	**0.1**	**0.0**
Quebec				
Budget Balance	2.5	2.8	3.2	3.6
Investment in Capital Assets	7.6	7.3	7.3	6.6
Net Borrowing	5.1	4.5	4.1	3.0
Fiscal Impulse as % of CAD GDP		**0.0**	**0.0**	**-0.1**
Alberta				
Budget Balance	-9.1	-8.8	-7.9	-7.0
Investment in Capital Assets	9.2	6.4	5.9	6.0
Net Borrowing	18.3	15.2	13.8	13.0
Fiscal Impulse as % of CAD GDP		**-0.2**	**-0.1**	**0.0**
Total				
Budget Balance	-25.4	-30.8	-28.8	-26.8
Investment in Capital Assets	33.1	35.0	38.2	38.1
Net Borrowing	58.5	65.8	67.0	64.9
Fiscal Impulse as % of CAD GDP				
Budget Balance		0.3	-0.1	-0.1
Investment in Capital Assets		0.1	0.2	0.0
Total		**0.4**	**0.1**	**-0.1**

N.B.: Federal infrastructure investment is the sum of Budget 2018 allocations of pre-2016, Budget 2016 and Budget 2017 infrastructure investment plans. Quebec investments in capital assets for 2019-20 and 2020-21 are estimated from net capital investments and depreciation.

Risks

Our base-case scenario of above-trend growth in Canada over the short term essentially rests on our projection of strong global growth, expansionary fiscal policy in Canada and firm commodity prices. Of course, there are risks to this scenario, both negative and positive.

The most important downside risk relates to the extent to which Canadian business investment and exports may be deterred not only by uncertainty regarding possible U.S. trade actions and retaliatory responses to them, but also by less favourable trading arrangements than at present with regard to NAFTA and WTO. As Section II concludes, "Canada will have to get used to living with a less certain NAFTA for at least another year."

A second downside risk is that business investment in Canada and exports will be significantly deterred by a loss of competitiveness relative to the United States due to regulatory and tax factors discussed in Section IV.

A downside risk for the medium term is that governments could have less room than warranted for fiscal stimulus in response to an eventual downturn in economic activity. Indeed, the 2018 budgets raise an issue for stabilization. With the exception of Quebec, budgets remain in deficit up to 2020 even as the economy is at its cyclical peak. This poses no immediate problem as long as growth remains at or not much below its potential rate. History, however, suggests that sooner or later the economy will experience a downturn. If negative shocks were to generate considerable slack in product and labour markets, the governments would have less room for deploying fiscal stimulus to revive growth than if they had taken the opportunity of a strong economy in the short term to balance their budget or generate surpluses.

Finally, volatile oil and commodity prices as always constitute both upside and downside risks to our projections. Oil prices could rise more than expected because supply expands less than foreseen, due to sanctions against Iran for example, or because demand increases more than anticipated due to stronger global growth than projected. Higher oil prices would tend to boost the Canadian economy as a whole, especially if they originate from stronger global demand, but the positive impact may be significantly reduced by a shortage of pipeline and rail capacity to transport oil to markets.

A fourth downside risk relates to the magnitude of the negative response of consumption and housing to the projected increase in Canadian interest rates. These responses should be larger than they used to be in the past because high household indebtedness would amplify the increase in debt service costs associated with any given increase in interest rates. Just how much greater the impact would be, however, is somewhat uncertain.

A final point to note is that if one or several of the above risks were to materialize in a significant way, the exchange rate of the Canadian dollar would most likely adjust so as to absorb part of the impact of the shocks. It is hard at this stage to state precisely what the projection and its risks imply for the future evolution of the Canadian dollar. We continue to think that the Canadian dollar will likely evolve in a fairly wide range, but around 77 U.S. cents instead of 80 U.S. cents as expected last fall as trade and competitive issues weigh more heavily on the outlook.

As the above risks suggest, Canadian businesses face significant additional challenges to their competitiveness in the years ahead, largely related to taxes, regulation and trade arrangements. In Section IV, next, we discuss some of the strengths, but also persistent and in some cases new or growing gaps in competitiveness and discuss the necessary policy response by governments.

Section IV:

A New Competitive Landscape—Situating and Positioning Canada

Shifting Goalposts

The macroeconomic environment of strong growth in both domestic and global demand creates opportunities for Canadian businesses, particularly over the next two years. However, to take full advantage of current momentum while mitigating risks for the medium term, our economy requires stronger private and complementary public investment in physical and human capital and in knowledge and innovation. This is necessary to expand potential output, boost productivity growth, and deliver outcomes better than what may otherwise be mediocre economic performance past 2020.

For businesses in Canada, investment decisions are complicated by shifting competitive ground. Already grappling with such factors as uncertain commodity prices and the disruptions of markets and business models brought about by technology, corporate executives and boards in Canada have to consider:

- the risks to their business and supply chain posed by a less certain NAFTA;
- the effect of U.S. tax reform on their trans-border investments and then on the comparative after-tax return of a marginal investment in Canada and the United States; and
- the effect of divergent economic policy directions in Canada and the United States.

For years, NAFTA and privileged access to the U.S. market have represented not only a critical asset for Canadian businesses but also a selling card for foreign direct investment. As discussed in the previous section, this asset is less certain today. Meanwhile, U.S. tax reform has taken away a clear-cut tax advantage for Canada as measured by marginal effective tax rates for new investment.[17] Calculations vary by sector, by province and state, and ultimately by individual business but on average marginal effective rates of tax no longer support a strong case for an investor to choose Canada over the United States.

Policy directions complicate the equation further. The Trump administration is easing environmental regulation affecting energy and resource development and reducing the compliance burden of regulation in a number of sectors, including financial services. This is lowering the cost of doing business in the United States relative to Canada where some sectors and some businesses face one or a combination of two factors: more expansive and stringent regulation to meet a widening array of policy goals; and uncertainty and costs caused by a less timely and less predictable regulatory process.

On the flip side, the U.S. administration's approach to immigration may enable Canada to offer a better proposition to businesses in accessing the best talent from anywhere in the world. Canada can also offer the benefit of lower public debt, a more solid fiscal situation, and a greater capacity to invest in productivity-enhancing public infrastructure.

Faced with this changing competitive landscape, both domestic and foreign businesses have no choice but to continuously reassess whether to locate in Canada or abroad their new investments in productive capacity—including machinery and equipment, intellectual property, and human capital. In turn, governments have a responsibility to implement responses to this environment to maintain and enhance the attractiveness of Canada as a place for enterprises to grow their business. In this section, we address the competitive challenges faced by businesses and governments.

Section IV: A New Competitive Landscape—Situating and Positioning Canada

The Competitiveness of the Business Environment

In deciding where to make investments the individual firm assesses a wide set of factors that determine the expectation of after-tax profit: the market opportunity and access to the market; the availability, quality and cost of the workforce; the availability and cost of financing; the regulatory framework and the cost of doing business; the infrastructure to deliver the goods to market; the ecosystem for innovation; and, at the end, the tax system for businesses and for individuals. This analysis is complex and must be carried out, firm by firm, while taking into account not only conditions today but also trends and developments affecting the horizon of the investments.

As gauges of competitiveness, some institutions globally construct indices that allow a ranking of the business environments based on a composite of all or some of the above factors, plus others in some cases. The indices typically consider a mix of quantitative variables and survey data that correspondingly provide a measure of both fact and perception in the comparison of countries.

Canada tends to perform respectably in such rankings, but not spectacularly and generally poorer than the United States. The World Economic Forum (WEF), the IMD World Competitiveness Center, and the World Bank rank Canada 14th, 10th and 18th for competitiveness in the world, respectively, compared with 2nd, 1st and 6th for the United States.[18] While Canada often likes to measure itself against the G7 and thereby draw favourable comparisons, apart from the United States, it is often smaller economies, like Switzerland, Singapore, or the Netherlands that do markedly better and that set benchmarks for Canada to match or to beat. A similar-sized resource-based economy, Australia, is a comparator against which Canada does reasonably well.

The surveys, in short, tell us that Canada is generally perceived to be less favourable than the United States as a destination for investment and only middle of the range of other advanced economies. While the surveys are imperfect, sometimes backward rather than forward-looking, and may reflect perception more than reality, they nonetheless constitute a message that is conveyed and heard by investors and that matters for investment decisions. The lesson for Canada is that we can, and should, do better. A new federal *Invest in Canada* agency will have the responsibility to frame and pitch the Canadian proposition to foreign investors and it will usefully provide feedback to governments on points requiring dedicated policy efforts.

Of note, the single competitive disadvantage for the United States cited most often in the latest WEF survey, published in September 2017, was tax rates. Clearly, the United States has since acted boldly to address this disadvantage. Canada, too, has to look closely at its major weaknesses.

In Canada, the aspect of the business environment that draws perhaps the sharpest criticism is regulation. The subject is addressed at length in a recent report by the Canadian Chamber of Commerce that cites complex, costly and overlapping rules.[19] Internationally, the surveys are also critical. For example, the factor cited most often in the WEF survey as the most problematic for doing business in Canada, ahead of tax rates and insufficient capacity to innovate, is "inefficient government bureaucracy" which can be readily associated with the regulatory process. This is not a matter of one government or one set of regulation, but how overall requirements placed on businesses—by federal, provincial, and indeed municipal governments—amount to costs, risks, and uncertainty.

A distinction must be made. It is appropriately the responsibility of governments to decide, based on an assessment of benefits, risks, and costs, and in consultation with industry and the public, the regulatory standards to be met by businesses. Indeed, high standards may be an important component of the Canadian brand. What is unambiguously detrimental to competitiveness is poor performance of the regulatory system: lack of clarity, overlap across jurisdictions, protracted process, litigation of policy issues in project reviews, relitigation in the courts, and ultimately indecision, or decisions by default when proponents simply abandon projects as market windows close.

The case that illustrates most vividly recent challenges in the regulatory environment in Canada relative to the United States is the energy sector (see "Competitiveness and Regulation" section). The costs and uncertainty faced by proponents to get energy and infrastructure projects reviewed, approved and built against a shifting policy, regulatory, and legal environment is impeding severely our capacity to realize the value of Canada's resources. Investment prospects in our upstream energy sector are further depressed by evolving and uncertain regulatory requirements across a range of government priorities and stand in sharp contrast with expected growth of energy supply in the United States that is unprecedented globally.

Because of the signal that Canada is not getting its act together in one of its traditional economic strongholds, the energy sector, the impact on the country's competitiveness is more significant still. For example, partners in Asia that expected to play a role in our energy sector as investor and client are disenchanted and this can reverberate far beyond energy. The recent decision by Kinder Morgan to pull out of Canada because of political, legal, and regulatory uncertainty with respect to the Trans Mountain Pipeline and Expansion Project (TMX) will clearly reinforce such sentiment. Getting TMX built by a Crown corporation or commercial successor will be a necessary—but not sufficient—condition to restore confidence and to demonstrate that Canada can move forward.

A Deep and Pervasive Challenge

Ultimately, the investment decisions of individual firms are reflected in macroeconomic trends. Based on the record and trends of the past years, challenges to our competitiveness are structural and pervasive. In the business sector, Canada has a growing labour productivity gap with the United States (Chart 2). Canada has maintained competitive unit labour costs in common currency only through depreciation of the Canadian dollar (Chart 3). In common currency, our workers are paid less—and that means lower real incomes.

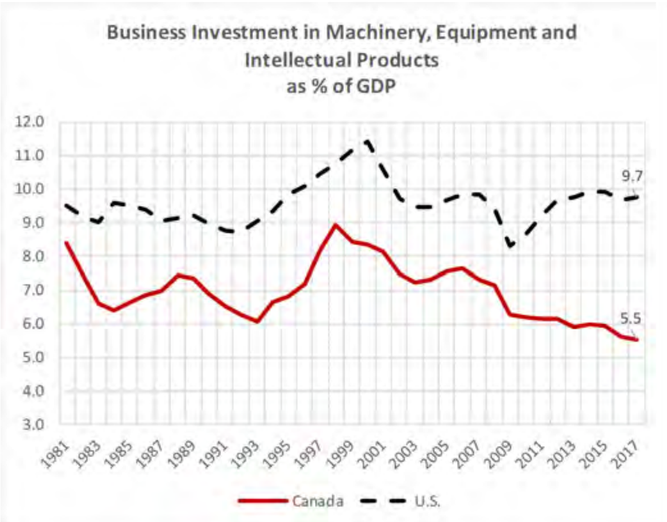
Chart 2

Sources: Statistics Canada and U.S. Bureau of Labor Analysis.

Chart 3

Sources: Statistics Canada and U.S. Bureau of Labor Analysis.

Chart 4



Sources: Statistics Canada and U.S. Bureau of Economic Analysis.

Of critical concern for Canada is low and declining investment in the key drivers of productivity. We have been over-investing in the residential sector and chronically under-investing in machinery and equipment (M&E), including information and communication technologies, and intellectual property (IP) (Chart 4). While the United States has rebounded since the Great Recession, Canada has continued to lose ground on M&E and IP investment and there is no sign of an inflexion point.

The recent report of the Expert Panel on the State of Science and Technology and Industrial Research and Development in Canada draws attention to a declining R&D intensity in Canada, with a widening gap relative to the average of the Organisation for Economic Co-operation and Development countries.

> "Even in areas where Canadian researchers and institutions played a seminal role in early research (and retain a substantial research capacity), such as artificial intelligence and regenerative medicine, Canada has lost ground to other countries."[20]

Such results are particularly problematic, the panel notes, inasmuch as the country also has comparative difficulty in monetizing the fruits of its R&D through the management and ownership of intellectual property.

Lower investment, lesser innovation, and lower productivity translate into a disappointing trade performance in a globally competitive global marketplace. As noted again by the Bank of Canada:

> "The steady downtrend in Canada's share of U.S. non-energy goods imports has not slowed despite the depreciation of the Canadian dollar in recent years and is indicative of the ongoing competitiveness challenges that some Canadian exporters face."[21]

Looking ahead to how Canada will position itself in the digital economy, under what is called the fourth industrial revolution, there is no comfort. Canada has strengths for sure, including a talented and mobile workforce, first-rate researchers, and world-class cities that can attract the best and the brightest. Our challenge is capitalizing on these assets and marketing successfully new goods and services. A 2016 WEF ranking of countries' "preparedness to reap the benefits of emerging technologies and to capitalize on the opportunities presented by the digital revolution" ranked Canada 14th globally, far behind Singapore, Finland, Sweden, Norway, and the United States in 5th place.[22] Canada is making some inroads and gaining prominence in some parts of the digital economy but there is much work to do to bring such successes to scale and to maximize benefits for Canada.

A Necessary Policy Response

Competitiveness gaps pose a direct and immediate challenge to our governments. They do not control the global environment in which our firms compete but they do control domestic levers and must use them to re-establish and improve competitiveness, notably relative to the United States.

On regulation, this starts by considering more systematically and more diligently the costs of regulation as well as the benefits. It is appropriate for Canada to establish high standards of performance in the pursuit of security, public health, environmental sustainability, consumer protection, and prudential soundness of the financial sector. However, regulation is about risk management where loss of economic opportunity is also an important risk that must be explicitly recognized. For regulation to be administered predictably and efficiently, it is important that it:

- focus on clear, stable and achievable outcomes rather than detailed prescriptive means;
- establish clarity and predictability of process, including timelines;
- resolve inter-jurisdictional overlap;
- enable a smooth transition and adjustment of the capital stock;
- minimize compliance costs through efficient administration; and
- enable businesses to move forward with investments under a reasonable set of conditions.

In Budget 2018, the federal government announced a modest investment ($11.5 million over three years) toward regulatory reform, focused on supporting innovation and business investment. The initiative will be informed by six private sector tables advising the Minister of Innovation, Science and Economic Development. The scale and intensity of the follow through in fact will need to match the significant risk that Canada is losing ground and that investors may be losing patience. The recommendations of the Canadian Chamber of Commerce will also merit close examination.

This critical challenge will be even more pointed in the digital economy that is re-drawing markets and changing the rules of the game. The regulatory framework will need to keep pace with the world of big data, artificial intelligence, and flows of services traded across borders. For example, the Government of Canada is developing in law and regulation the parameters for the engagement of our banks and other federally-regulated financial institutions in fintech in ways that will foster innovation while ensuring consumer privacy, prudential soundness, and competitive equity.

On taxation, the Government of Canada was right not to precipitate a response to U.S. tax reform in Budget 2018. The U.S. reform is more than a simple rate cut. It affects differentially sectors and businesses over time and its impact on inbound and outbound investment is complex. But a response is required; any complacency would be misguided. The timing is right over the next months to complete the analysis and deliver tax legislation that will incite greater capital investment in productive capacity and the location in Canada of mobile factors, including talent and intangible assets.

Concrete initiatives and a firm medium-term direction would usefully be set out ideally in the next federal budget or even earlier. If not immediately affordable, measures could be phased in over time, for example on a schedule of five years, sending clear signals.

On corporate taxation, there are two basic approaches:

- a cut in the statutory tax rate possibly offset in part by a broadening of the tax base (e.g., by taking a page from U.S. tax reform and tightening the rules for deductibility of interest costs); and/or
- measures, such as accelerated depreciation, or tax credits, that target new investment only.

“Boutique” initiatives are unlikely to be successful. Options will best be weighed on the basis of material, potential contribution to investment and to a wider economic strategy encompassing key drivers of future prosperity. Corporate income tax initiatives may need to be complemented by personal income tax measures. For example, there is a need to reflect on marginal rates in income brackets that apply to mobile knowledge workers and entrepreneurs that will drive innovation.

While careful restructuring of our tax system is required in response to changes in the U.S. tax code and other competitive pressures, this cannot be achieved at the expense of a sharp deterioration of the fiscal position of Canadian governments. In fact, making tax changes within a responsible fiscal framework for the medium term is one way for Canada to distinguish itself favourably from the United States where the structure of taxation and expenditure is unsustainable.

Indeed, a competitive investment climate entails preserving an important advantage: a stronger fiscal position, with lower fiscal deficits, lower debt service costs and much lower (unfunded) future payments for social security. The recent sharp increase in net borrowing by the federal and provincial governments (Table 4) creates the perception that Canada is at risk of losing this advantage. While borrowing to make productive capital investments can contribute to future growth, borrowing to cover operating deficits at the top of the business cycle impairs the ability of governments to deal with future economic downturns. Competitive taxation and expenditure have to be addressed together.

On other determinants of the competitiveness of the business environment, federal, provincial and indeed municipal governments can work together to design and execute policies that will send improved signals. This will include collaborative and integrated policies in such domains as:

- education, life-long learning, labour markets and immigration policies to equip Canadian businesses with the best possible workforce;
- infrastructure, including by drawing on private sector participation in the planning, design, financing and operation of productivity and trade-enhancing projects, including through the new Canada Infrastructure Bank; and
- innovation, including the diligent implementation with private sector leadership of the federal superclusters initiative as a new, more targeted approach to support excellence on a global stage.

Ultimately, it is the responsibility of businesses to invest, innovate, grow and diversify their markets. With a new competitive playing field affected by U.S. steps, corporate leaders are assessing carefully their options. The marginal dollar of investment is highly mobile.

It is the responsibility of governments to create the conditions that will give businesses confidence that they may invest in Canada and earn a competitive, after-tax return now and into the future. Action—the right policies and then disciplined execution—is necessary today to affect the reality and perception of the competitive environment over the medium term so that Canada may be better positioned to grow beyond a favourable short-term horizon.

Competitiveness and Regulation: The Case of the Energy Sector

In no sector of the economy has Canada's competitiveness with the United States worsened more measurably—and with visible and potentially wide and long-lasting impacts—than in the energy sector.

The contrast between the United States and Canada in this sector is stark. The United States is projected by the International Energy Agency to realize by 2025 the highest sustained period of oil output growth by a single country in the history of oil markets while also becoming the world's largest liquid natural gas (LNG) exporter. Meanwhile, Canada's oil and gas industry is contemplating a risk of stagnation of investment and supply beyond this year and next. The dominant factors holding back our industry has been and remains protracted delays and the uncertain prospects of construction of infrastructure to get our oil and natural gas resources to new markets.

The recent decision by Kinder Morgan to abandon its Trans Mountain Pipeline and Expansion Project (TMX) is a dire expression of frustration with a costly and uncertain political, legal and regulatory environment to build a new infrastructure project despite undisputed, compelling economics. The drastic step by the Government of Canada to buy the assets of Kinder Morgan indicates a strong willingness to get TMX built, but it provides at this time no certainty of outcome.

The continuing gridlock—after failure to date to get other oil pipeline projects approved and built—not only impedes the development of our resources over the medium term, it is penalizing Canada severely today in the form of lower prices. For oil, the impact on the industry of bottlenecks in the transportation infrastructure, as measured by the corresponding, added differentials between Canadian and world prices, amounts to something in the order of $10 billion annually, or 0.5% of GDP.[23]

This is not a handicap caused by lack of demand for our resource, or by the unwillingness of committed investors or shippers to bear normal economic risk. It is, quite plainly, the cost to our economy of excessive political risk—an inability of public authorities collectively to overcome regulatory, legal, and political challenges even where the national interest is at issue.

Similarly, years of uncertain market and policy signals have held back LNG projects that would be critical to realizing value from vast resources in British Columbia and Alberta.

For investors contemplating opportunities in a global market, the contrast in the broader regulatory environments between the United States and Canada is making the decision to invest in Canada at this time more difficult still. The U.S. administration has adopted a deliberate pro-investment stance for the oil and gas industry. Regulations from the Obama administration are being dismantled and the areas of U.S. continental water open to oil and gas drilling are being vastly expanded. Whatever the long-term public policy merits, the signals to the industry are clear.

In Canada, the energy industry, from upstream to downstream, is confronted with a series of regulatory initiatives as governments advance more ambitious environmental agendas. At the federal level only, this includes: legislative proposals still making their way through Parliament for a new *Impact Assessment Act*, a new *Canadian Energy Regulator Act*, and reforms to the *Fisheries Act*; a new framework for a backstop, and rising carbon price across all Canadian jurisdictions starting in 2019; the coming into force of methane emission regulations in 2020 (while corresponding American rules have been rescinded by the U.S. administration); a new clean fuel standard for refiners; and new standards for gas-fired electric power generation. While each measure pursues defensible goals, together they significantly affect conditions for investment.

The investment environment is further unsettled by the recent passage by the House of Commons of Bill C-262, An Act to ensure that the laws of Canada are in harmony with the United Nations Declaration on the Rights of Indigenous peoples. While the government has stated that its endorsement of the Declaration does not create a veto for Indigenous peoples over development, this legislation now proceeding to the Senate poses added uncertainty and risks. It is not simply a matter of how the government of the day interprets its obligations but how the declaration and legislation may be interpreted and applied in the future by governments and by the courts.

The above does not cover provincial or territorial processes as well as local permitting that have also been moving targets. NIMBY obstruction has been bolstered, rather than discouraged, through ever more expansive public and community engagement in project reviews.

The result is unprecedented capacity for sub-national jurisdictions, Indigenous peoples, and local groups to obstruct and delay investment even where the regulatory and industry standards of environmental performance and community engagement are world-class.

With oil and gas investment in 2017 about one half its level of 2014 before oil prices retreated sharply, regulatory factors are impeding what could otherwise be a positive response to the partial price rebound. Of course, this is accentuated by U.S. corporate tax reform—including the rate cut and the temporary full expensing of capital costs—that may be a decisive factor for locating a capital-intensive projects such as an LNG plant.

As noted by the Bank of Canada:

> "In the energy sector, which accounts for roughly 20% of business investment in Canada, the Bank forecasts that investment will decrease in 2018 and remain roughly flat thereafter. Investment in new projects is being held back by reduced competitiveness resulting from regulatory and U.S. policy changes."

The electric power sector is equally challenged by the growing regulatory burden and costs, making it less attractive to invest in replacement or new infrastructure capacity, including clean energy projects and inter-ties. Canada's mining sector is confronted by the same risks and costs.

Infrastructure spending may also suffer from regulatory deficiencies. The new Canada Infrastructure Bank, in particular, may find that regulatory complexity will be a difficult hurdle to overcome in moving large projects forward and securing the interest of investors.

Section V:
Some Planning Parameters for Canadian Businesses

Based on the previous analysis, we advise business to plan on the assumption that global demand growth will be strong in 2018 and 2019, especially in the United States among the advanced economies. But growth will slow down markedly toward potential in 2020 and risks even falling well-below trend for a while in the worst case of a surge of inflation and interest rates in the United States in 2019. Thus planning on the basis of strong growth in the short run and only modest growth in the longer run seems most appropriate to us. Consistent with this view, WTI oil prices can be assumed to fluctuate around US$65 to US$70 in 2018 and 2019 before retreating to around US$60 to US$65 in 2020.

The Canadian economy will share in the robust global expansion in the short term and on net will benefit from higher prices for oil and other commodities, but likely less than might have been expected in the absence of headwinds such as uncertain future U.S. trade actions and NAFTA arrangements, the loss of competitiveness associated with U.S. deregulation and TCJA, and issues with transportation capacity in Canada. Overall, it would be prudent for businesses to plan on the basis of Canadian growth of about 2.0% to the end of 2019, 1.8% in 2020 and somewhat lower thereafter.

We think that it is reasonable for businesses to base their financing plans on the assumption that the Federal Reserve will raise its target Federal funds rate (upper limit) to 2.5% to 2.75% by the end of 2018 and to 3.0% to 3.5% by the end of 2019 or the first half of 2020. Similarly, a reasonable planning assumption for Canada is that the Bank of Canada will raise its policy rate to 1.75% by the end of 2018 and to 2.5% to 3.0% by the end of 2019 or the first half of 2020.

Business should base their financing plans on the assumption that 10-year U.S. treasury bonds will yield close to 3.5% by late 2019 and that risky spreads will be wider than they are today.

Based on our assumptions concerning oil prices, growth and policy interest rates in the United States and Canada, we would judge it appropriate to plan on the basis of an exchange rate moving in a fairly wide band centered on 77 U.S. cents. Considerable volatility is to be expected.

Table 5

KEY PLANNING PARAMETERS FOR 2017-19

	2018	2019	2020
U.S. GDP Growth (%)	2.9	2.6	2.0
Canadian Growth (%)			
Real GDP	2.1	2.1	1.8
Household Consumption	2.6	2.1	1.7
Business Non-Res. Investment	3.7	2.8	2.8
Interest Rates (Year-End) (%)			
BOC Target Overnight Rate	1.75	2.75	3.0
10-Year GOC	2.6	3.25	3.25
10-Year U.S. Treasuries	3.1	3.5	3.5
U.S. Fed Funds Rate	2.25–2.5	3.0–3.5	3.5
Exchange Rate US$/C$ (Year-End)	0.77	0.77	0.77
WTI Oil Price (US$/bbl)	70.0	65.0	60.0

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Notes

1. As measured by the year-to-year change in the price index of consumption expenditures excluding food and energy, the measure preferred by the Federal Reserve.

2. The Federal Reserve's target policy rate would have to rise to even more than the projected 3.0% to 3.5% in 2019 were it not for a faster projected increase in potential GDP associated with the pick-up in business investment and labour supply resulting from the TCJA (see Chart 1A in Annex 1).

3. Congressional Budget Office, *The Budget and Economic Outlook: 2018-2028*, April 2018.

4. See Section IV.

5. Gavyn Davies, "The economic damage from a trade war", *Financial Times*, March 19, 2018.

6. Potential GDP refers to "an economy's capacity to produce goods and services when all available productive resources—specifically, labour and capital—are used to their fullest". See L. Schembri, "The (Mostly) Long and Short of Potential Output", Remarks to Ottawa Economics Association and CFA Society Ottawa, May 16, 2018. Potential GDP depends on the trends in the quantity and quality of capital and labour and in the efficiency of the production process.

7. Note that TCJA increases the user cost of capital for owner-occupied housing from 2018 through 2025 and for research and development beginning in 2022.

8. Based on these figures, TCJA would boost U.S. federal debt held by the public by 3.9% by the end of 2020 and by 6.6% by the end of 2027. See CBO. *The Budget and Economic Outlook: 2018 to 2028*, April 2018.

9. Without taking into account the feedbacks of higher debt service costs and higher taxable incomes, the cumulative deficit by 2027 would reach $1.5 trillion according to the Joint Committee on Taxation and $2.3 trillion according to the CBO.

10. https://insidetrade.com/sites/insidetrade.com/files/documents/2018/may/wto2018_0231.pdf

11. See Section V of the *Bennett Jones Fall 2017 Economic Outlook*, https://www.bennettjones.com/Fall2017EconomicOutlook.

12. This development was anticipated in Section IV of the *Bennett Jones Fall 2017 Economic Outlook* which also looked at the potential impact of American withdrawal from the NAFTA.

13. See the speech of Deputy Governor Leduc on May 31, 2018.

14. We took on board the upward revision that the Bank of Canada made in April to its estimates of the recent level and projected growth rate of potential GDP.

15. On balance we judge that these factors are likely to subtract about 0.2 percentage points from annual GDP growth over 2018-20. If in fact NAFTA actually collapses the negative impact by 2019 could be much greater.

16. Net borrowing here corresponds to the sum of budget deficit and investment in capital assets (infrastructure for the most part).

17. See Philip Bazel, Jack Mintz and Austin Thompson, 2017 Tax Competitiveness Report : The Calm Before the Storm, School of Public Policy, University of Calgary, Research Paper, February 2018.

18. See World Economic Forum, The Global Competitiveness Report 2017-2018; IMD World Competitiveness Center, IMD World Competitiveness Ranking 2018; World Bank, Doing Business 2018.

19. The Canadian Chamber of Commerce, *Death by 130,000 cuts: improving Canada's regulatory competitiveness*, May 2018.

20. Expert Panel on the State of Science and Technology and Industrial Research and Development in Canada, Competing in a Global Innovation Economy: the Current State of R&D in Canada, Council of Canadian Academies, 2018

21. Bank of Canada, Monetary Policy Report, April 2018.

22. World Economic Forum, Networked Readiness Index 2016.

23. See Scotiabank Global Economics Commodity Note, *Pipeline Approval Delays: the Costs of Inaction*, February 20, 2018. This study cites an estimated annual cost for the industry of $15.6 billion. This is on the assumption of an average price differential for Western Canadian Select (WCS) relative to West Texas Intermediate (WTI) of $21.60, higher than the current (end of May 2018) differential of some $16 per barrel. The study also calculated an annual loss of $10.7 billion on the assumption of an average WTI-WCS differential of $18 per barrel.

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