LETTER FROM THE PRESIDENT

Vol. 103

Wisdom from the Asian Financial Forum and the lessons for Canadian policymakers

HIGHLIGHTS:

The rise of populism has taken hold in the developed world from eroding living standards and shrinking job opportunities as persistently weak economic growth has collided with sweeping structural change in job markets from technology and globalization.

This "new normal" of lost opportunity is unsustainable. Governments must find consensus for pro-growth policies to break the economic malaise, embracing low tax rates, broad tax reform, stimulative spending, and deregulation, and avoid the impulse for excessive social spending and protectionism. Failure risks political pressure for even more radical policy solutions, placing the economy on a trajectory of downward spiralling growth.

Signs point to a strengthening recovery in the United States, if the Trump Administration and Congress achieve significant tax reductions, broad deregulation, and increased infrastructure spending, without setting off major dislocations in global trade. The jury is out.

INTRODUCTION

There was a great deal to discuss at this year's Asia Financial Forum (AFF) on January 16-17, at which I led the Canadian delegation at the invitation of the Hong Kong Trade Development Council.

This year marks the 20th anniversary of Hong Kong's handover from the U.K. to the People's Republic of China. Despite initial doubts about the future, Hong Kong has scaled new heights, benefiting from a "one country, two systems" arrangement. It has capitalized on its strengths in transportation and logistics; its intelligence on markets and economies in Mainland China and Southeast Asia; and most important of all, its fidelity to the rule of law and supremacy of its judicial system. It took advantage of opportunities in rapidly growing Mainland China. Hong Kong's reputation as an international city was a major factor behind China's ability to attract foreign capital and go global.

2017 also marks the tenth anniversary of the creation of the AFF, which brings together business leaders, government officials and regulators, and high-profile speakers and panelists, to discuss economic and financial developments and trends in Asia, and opportunities and challenges in the region.

Additionally, it has been almost a decade since the onset of the global financial crisis, which left governments and financial regulators scurrying to keep the system afloat and put in place regulations and institutions to prevent another meltdown. The AFF has explored the origins and impact of the financial crisis on the Asian region. Conference participants discussed the consequences for Asia of the frenetic pace of trade and financial globalization that has engulfed all countries, and the emergence of the so-called "new normal" marked by weak GDP growth and low interest rates that has unfolded as a troubling, persistently enduring economic condition, rather than a cyclical phenomenon.

Top of mind at the AFF was the "One Belt, One Road" initiative—a massive infrastructure and trade development project linking Mainland China to Central Asia and Europe, and also to South Asia through a maritime route through the South China Sea and Indian Ocean. The project has strategic importance in drawing the entire Asian region into closer economic and political relationship with China. Panelists also addressed the rapid adaption of technology in financial markets (FINTEC) and in the expanding area of cybersecurity. The conference delegates also discussed the economic and trade outlook for the region over the coming year, and the risks from instability in the regional and global financial systems, from disruptions in traded markets and from geo-political shocks.

The conference proceedings, however, were dominated by the rise of populism in the politics of the developed countries, notably the United States and Britain.

POPULISM: MANY FACTORS DRIVE IT

Declining living standards, rising income disparities, persistently high unemployment, increased immigration flows and the growing disconnect between the agenda of the political elites and the concerns of the governed, have given rise to widespread fear and anger, and the demand for new policy direction. Some of these consequences come from the stagnation in incomes and employment, but others are the inevitable outcome of globalization and technological progress—trends that cannot be reversed without adverse consequences. Nevertheless, this political populism has given rise to the election of Donald Trump in the United States and the unexpected Brexit decision in the United Kingdom, the rejection of the Italian constitution in that country's referendum and the prospect for more nationalist governments in impending elections in France and Germany.

THE NEW NORMAL EVENTUALLY CLEAVES INTO ONE OF TWO ALTERNATIVE PATHS: REFORM OR GRIDLOCK

One of the keynote speakers at the AFF conference, Mohamed El-Erian, Chief Economic Advisor at Allianz and former CEO and co-CIO of PIMCO, shared key insights on this rising populism. He explained this populism, or political backlash, as the outcome of the "new normal", characterized by expansionary monetary policy, low interest rates, weak investment, high unemployment and protracted slow economic growth. El-Erian argued this "new normal" largely reflects the exclusive dependence on monetary policy to provide economic stimulus, in large part, because political gridlock in many countries, particularly in the U.S., made larger fiscal stimulus policies impossible. He argued that 2012 was a pivotal year for the U.S. Federal Reserve. Congress was recognized as hopelessly gridlocked and incapable of providing effective fiscal stimulus. At the time the Fed took on the full burden for supporting economic recovery through continued accommodative policy, including a third round of quantitative easing (QE3), announced in September 2012.

Fiscal policy was even more hamstrung and dysfunctional in Europe because responsibility rested with the different governments within the EU, with different views on the merits of stimulus.

In El-Erian's view, the "new normal", even though it has lasted eight years, is unsustainable, given the building economic and political pressures. The process will reach what he termed a "T-junction," and would take one of two directions. One will lead to higher growth, reduced financial risk and a lessening of inequality; the other will see all those measures head in the wrong direction. The first direction will result from consensus building around constructive, pro-growth policies, embracing low personal and corporate tax rates, wholesale tax reform, active engagement of public and private partnerships for infrastructure spending, and widespread deregulation (i.e. pushing back on regulation and mandating a rigorous cost benefit analysis).

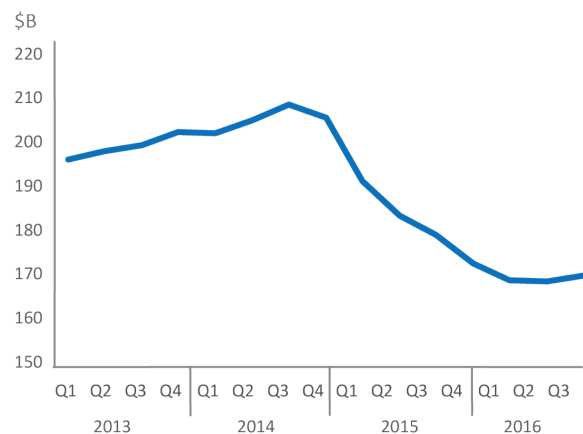
The serious economic and social consequences of continued drift in the "new normal" would drive this consensus for a shift in policy direction. The adjustment would be vigorous and multi-dimensional to unleash animal spirits and build business and consumer confidence. This would provide the best prospect of breaking out of the deepening economic lethargy, in effect achieving so-called economic escape velocity.

In the alternative scenario, governments would fail to achieve any political consensus for pro-growth policies, especially lower tax rates and deregulation, penalized by political gridlock and dysfunction within the government political party or across political lines. As the economic and political pressures built, easy money risks asset bubbles and financial market instability and inflation. Public finances deteriorate from weakening growth and stepped-up spending, and pressures build for protectionist policies. In these circumstances, the economy spirals into ever-weakening growth.

WHAT PATH FOR CANADA?

Canada is in the same predicament as many economies in the developed world, caught in its own version of the "new normal"— this extended period of sluggish investment and slow growth. Commodity prices are expected to remain low, while sub-par growth and poor employment prospects, and uncertainty about the economic outlook is weighing on many Canadians. Signs point to continued soft household income growth, and high and rising taxes. These conditions argue for a vigorous shift to pro-growth economic policies.

1. The federal government plans for increased infrastructure spending to stimulate economic recovery is well intentioned and a sound policy prescription. Modern and efficient infrastructure is a key component of business and economic competitiveness. However, infrastructure spending is unlikely to have a positive impact on growth in the near term given the decision to establish a detailed government-private sector decision-making framework, with the Canada Infrastructure Bank at the core, for effective project spending, and the inevitable delays in start-ups, even when projects are approved. The government should look to private sector financing models to promote infrastructure development. The private sector can bring new ideas, innovation and real-time oversight and product management expertise.



Business investment excludes residential construction
Data Source: Statistics Canada

2. The challenge with infrastructure spending is that it is not just about identifying economically viable projects and mobilizing capital. It is about the need for effective mechanisms to resolve competing interests to allow larger projects to proceed. The Financial Post has identified as many as 35 Canadian infrastructure projects worth $129 billion in direct investment (mostly private money) that have been stalled or cancelled as a result of opposition from environmental, aboriginal and community groups.

3. Sustained economic growth depends on private-sector

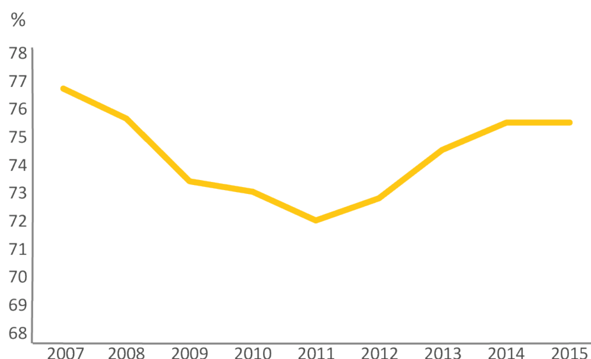
investment. Business investment in Canada contracted for a second straight year in 2016 reflecting a sharp drop in capital spending in the oil and gas sector. However, non-energy private sector investment also pulled back. From a policy perspective, governments need to address the regulatory burden, high taxes, and high costs (e.g. electricity prices in, say, Ontario) that may be a hindrance to business investment.

4. Small and mid-sized businesses in Canada have difficulty raising capital in private and public markets to finance expansion and jobs. These businesses could benefit from a market-driven tax incentive to assist in raising external capital in public and private markets. The IIAC has proposed the federal government adopt a Canadian version of the successful U.K. Enterprise Investment Scheme to encourage capital formation and promote the growth of mid-sized Canadian enterprise.

   These mid-sized companies, particularly in the value-added manufacturing sector, offer the best prospects for employment and growth. Successful manufacturing enterprises like Linamar and Magna, operating successfully in Ontario, demonstrate that Canadian businesses once at critical mass can become effective players in global markets.

5. Canada's non-resource export sector has not expanded as anticipated with a depreciated Canadian dollar. The NAFTA trade agreement, under siege by the Trump Administration, is critical for Canadian business to succeed. The decisive action of the federal government to defend NAFTA in negotiations with the Americans is commendable. Further, the decision to expand free trade deals, including with Europe and China, is a positive step. Canadian exporters who have traditionally looked exclusively to the U.S. market now understand that they must also turn their sights towards new promising markets, including those in Asia and Latin America. Developing countries are investing significantly in transportation networks, power generation and renewable energy—areas in which Canada has tremendous expertise. They require a full range of commodities, technologies and services Canadian businesses can provide.

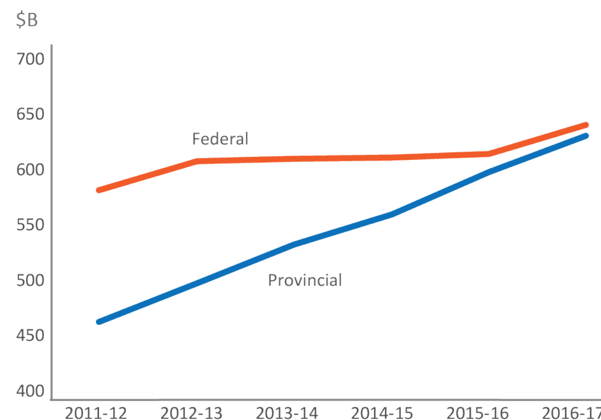
Canada's Merchandise Exports
U.S. share of total



Data Source: Statistics Canada

6. The personal tax burden in Canada is already too high and acts as a drag on growth, with the top combined federal/provincial marginal rate in Ontario at 53.5 percent, and the combined top rate well above 50 percent in every province except British Columbia, Alberta, Saskatchewan and Newfoundland. In the U.S., the top federal/state marginal rate stands at 46.3 percent, and kicks in at a much higher income level. Further, this combined marginal tax rate doesn't include GST, carbon taxes and real estate taxes borne by average Canadians. High marginal rates discourage work, saving, risk taking and entrepreneurship. It is also important to recognize shifting a higher tax burden onto higher-income Canadians is not sound public policy. Many developed countries are facing an aging population and slower growth in the labour force. We must do everything we can to attract and retain skilled workers that are essential to our international competitiveness. High marginal personal income tax rates do not help our cause. If the government is going to run large deficits, it should use the money to reduce punishingly high marginal tax rates.

Federal-Provincial Net Debt



Data Source: Department of Finance Canada; various provincial budgets

7. Federal public debt stands at an estimated $642 billion, roughly 32 percent of GDP. Despite a relatively low debt-to-GDP ratio in OECD country rankings, federal debt is projected to rise a further $104 billion over the next four years, pushing total federal debt to $746 billion by fiscal 2021-22. Roughly $25 billion annually goes to service the debt, and this will rise to $33 billion in fiscal 2021-22. More seriously, if provincial debt is included in the debt totals, overall government debt is roughly $1.4 trillion, or 67.5 percent of GDP, boosting Canada well up in the OECD debt rankings. Ontario's debt stands at $317.9 billion, nearly half the federal debt. This debt has doubled in the last decade.

8. Debt service costs escalate sharply as the debt load rises, and are vulnerable to rising borrowing costs. These interest costs limit government policy options for reducing taxes and for increased infrastructure spending. Moreover, this borrowing surreptitiously pushes the repayment burden onto the younger generation without commensurate improvement

in future incomes and job opportunities. Governments need to rein in spending to eliminate deficits so they have the flexibility to respond to changing circumstances.

9. Climate change is an important consideration and must be addressed. However, Canada's commitment to reduce emissions must be calibrated carefully, weighing the benefits of emission cut-backs to the environment against the economic costs. For example, Ontario commitment to renewable energy have not been done in the context of an effective cost-benefit analysis, placing an excessive burden on Ontario residents and damaging business investment prospects in the province.

10. Canada's economy has been struggling to achieve momentum. Real GDP expanded 0.9% in 2015 and by an estimated 1.3% in 2016. As noted above, business investment likely contracted for a second straight year. Household debt is at record high levels. Employment growth has remained stable at close to a 1% increase year-on-year, enough to keep the jobless rate at around 7%. However, this concealed a large shift in demand for part-time positions. It is hard to believe that frustrations will not translate into the demands on politicians for changes in policy direction.

THE AGENDA LOOKS POSITIVE – BUT WHAT WILL BE THE ACTUAL DECISIONS?

Canadians are watching with great interest what the Trump Administration might bring. The financial markets and commentators have cheered the new Administration's pro-growth policy agenda of lower taxes, deregulation and infrastructure spending. U.S. Federal Reserve officials recognize the positive economic impact of this proposed stimulus program, but cautioned that results will depend on the timing, magnitude and composition of these policies, the cyclical position of the economy, and the responses of the dollar and longer-term interest rates. A further cause for concern is the prospect of protectionist policies that could damage the U.S. and global growth.

The Canadian government needs to move in lock-step with this pro-growth agenda, both to strengthen domestic economic growth and improve the competitiveness of Canadian business. This must be done in the context of fiscal scope and other commitments that Canada has, particularly the advantages of greater flexibility from a stronger fiscal position. Policies that encourage investment in jobs is the best assurance for improving living standards and the lives of ordinary Canadians.

Yours sincerely,

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