

Relatively Speaking

CANADA IN A CHANGING AND UNCERTAIN WORLD

Kevin Lynch and Karen Miske



We face a future that will be volatile, uncertain, and profoundly changing. Structural trends are reshaping economics, politics, power, and expectations around the world. Relatively speaking, Canada is in good shape, write Kevin Lynch and Karen Miske of BMO Financial Group. We face the future with clear strengths, including solid macroeconomic policies, a diversified economy with rich natural resources, a well educated labour force, a sound financial system supported by a strong framework of public institutions, and an enviable standard of living. Canada has the potential to adapt to this changing world, but we must aim to be at the forefront of the new competitiveness, avoiding complacency and building on our strengths.

Notre avenir s'annonce instable, incertain et profondément transformé. Les tendances structurelles à l'œuvre dans le monde entier refaçonnent les économies et les attentes, les politiques et les pouvoirs. Les perspectives du Canada sont toutefois relative-

ment bonnes, estiment Kevin Lynch et Karen Miske, de BMO Groupe financier, qui citent parmi ses forces de solides politiques macroéconomiques, une économie diversifiée fondée sur d'abondantes ressources naturelles, une main-d'œuvre bien formée, un excellent système fi-

nancier soutenu par de robustes institutions publiques et un niveau de vie enviable. Le Canada a donc tout ce qu'il faut pour s'adapter à l'évolution du globe, mais il doit refuser toute complaisance et miser pleinement sur ses forces pour dominer cette nouvelle course à la compétitivité.

As the ballad goes, “the times, they are a-changing”. The context we now face is pervasively global and profoundly changing, whether we always like it or not. Structural trends are reshaping economics, politics, power, and expectations around the world. The international economy continues its shift to Asia and other dynamic emerging economies. The aging population in most developed nations is creating a global talent competition. The digital universe is transforming what markets mean and how social interaction and communication take place.

The global outlook is dreary. This fall, we saw a write-down of the International Monetary Fund’s (IMF) global growth forecast, as an already tepid global recovery suffered new setbacks with the eurozone back in recession, the US economy losing some momentum, and slowing growth in the BRIC countries (Brazil, Russia, India, and China). The growing worry is that Europe and the United States are exhibiting many of the characteristics of Japan’s “lost decade” after its property bubble burst in the early 1990s – certainly not good news. Indeed, for the OECD countries, this recession and recovery really are different – the 2008-09 recession was the worst in the postwar period by a country mile, and the recovery is outside historical bounds, particularly in the US and Europe.

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And there is considerable risk. The IMF now foresees “only a gradual strengthening of activity from the relatively disappointing pace of early 2012”, and believes “the downside risks have increased, and are considerable”. Mixed with the slowdown in China, this uncertainty is becoming a problematic feedback loop, restraining spending plans by corporations and families in many countries.

In this changing world, the drivers of success are also shifting. Today, it takes a global perspective to serve markets beyond one’s traditional boundaries. It takes an ability to attract and retain talent. It takes a capacity for continual innovation and sustained productivity growth. In this new normal, stable and trusted institutions, sound economic and policy fundamentals, and attractive communities create national advantage.

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Canada’s relative global strengths include

- solid macroeconomic policies with low inflation;
- a diversified, sophisticated economy;
- abundant natural resources;
- a well educated labour force and an enviable standard of living;
- a sound financial system with world-class financial institutions; and
- a strong framework of public institutions and rule of law.

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The Canadian budget deficit on a total government basis (as a percent of GDP) is low relative to G7 countries (figure 1). Net debt as a percent of GDP for Canada in 2012 is projected to be 37.8 percent of GDP, less than half that of the US and well below all other G7 countries. This relative strength is expected to remain; the IMF expects that our net debt as a share of the economy will be 41 percent of the US by 2016 and well below the EU and UK (figure 2). And, the federal budget will be back in balance by then.

Figure 1 Annual total government surplus or deficit, various years (% of GDP)

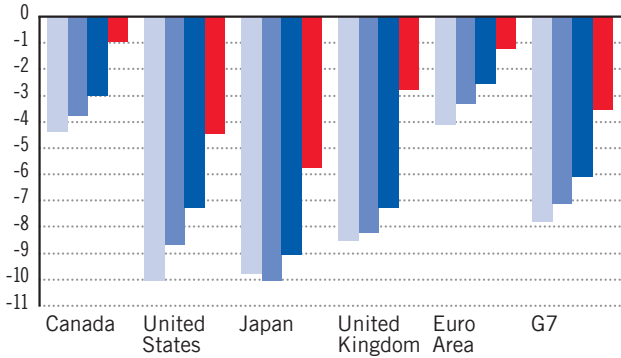
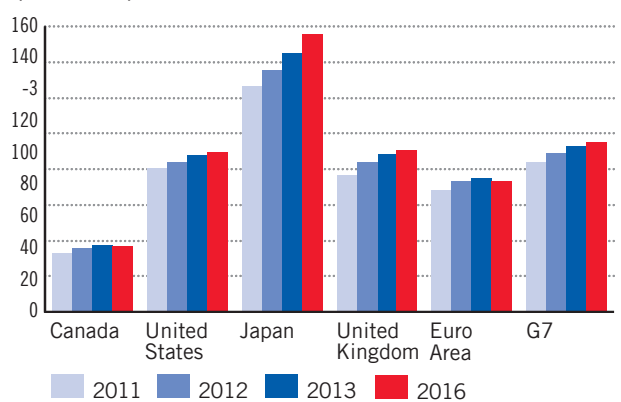
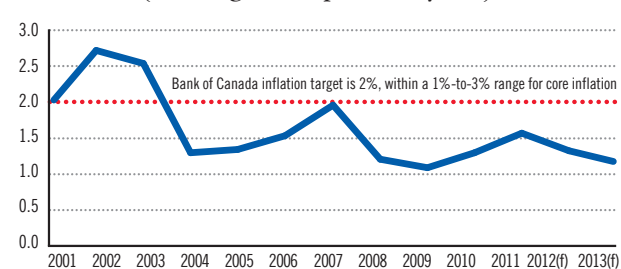


Figure 2 Total government net debt, various years (% of GDP)



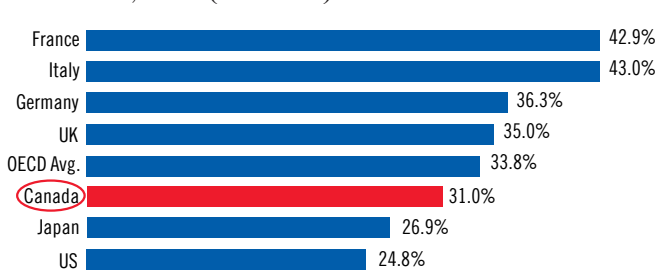
Source for figures 1 and 2: IMF World Economic Outlook (October, 2012) Note: Figures include all levels of government.

Figure 3 Core consumer price index (CPI), Canada 2001-2011 (% change from previous years)



Sources: Statistics Canada; BMO Capital Markets forecasts, October 2012.

Figure 4 Total tax revenues in selected OECD countries, 2010 (% of GDP)



Japan and OECD average tax revenue is for 2009.

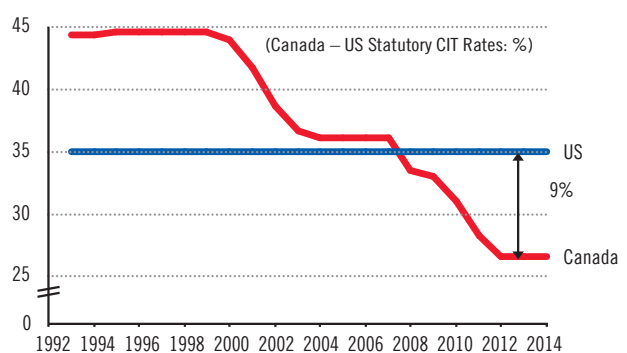
Source: OECD 2011.

Canada has kept inflation within a target range of 1 to 3 percent (a 2 percent midpoint target) on average for more than a decade (figure 3). Canada led the G7 in implementing an inflation rate target regime in 1991 and such a policy has now been adopted by over two dozen central banks around the world.

Importantly, total Canadian tax revenues (as a share of the economy) continue to be below both the OECD and G7 averages (figure 4). Lower taxes, particularly on capital and companies, improve competitiveness, growth, and job creation, and encourage investment in Canada by both Canadians and non-Canadians. Corporate statutory income tax rates (combined federal-provincial/state) are 9 percentage points lower than the US (figure 5).

Canada is a large producer of commodities that are needed by the world – forestry, agriculture, minerals, and energy products. Canada ranks in the top three countries globally for the production of potash, titanium, forestry products, uranium, aluminum, natural gas, lentils, peas, and oats (figure 6) – many of which are critical to supporting the growing demands of the burgeoning middle class in emerging markets such as India, China, and Brazil that constitute huge opportunities for Canadian industry. Canadian firms are also leaders in downstream activities including food processing, medical devices, and environmental engineering.

Figure 5 Statutory corporate tax rates in Canada and the US, 1992-2014



Sources: Canada (Combined Federal and Ontario Statutory income tax rate for General Corporate), Haver Analytics, IRS.

Figure 6 Canada's rank in global production of select forestry, agriculture, minerals, and energy products

Commodity	Ranking
Potash	1st
Titanium	1st
Lentils	1st
Peas	1st
Oats	1st
Canola	1st
Forest	2nd
Uranium	2nd
Aluminum	3rd
Natural Gas	3rd

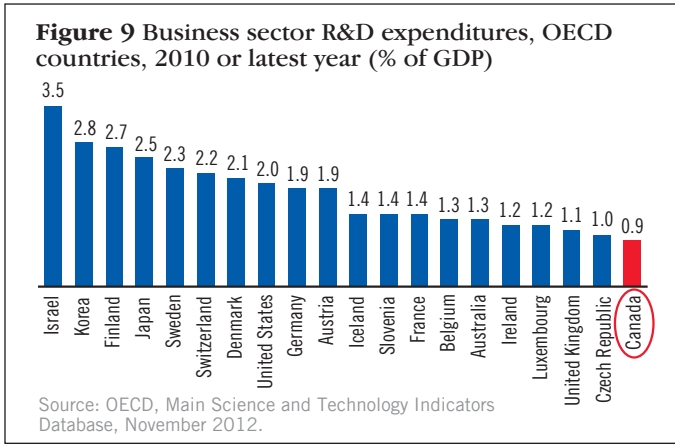
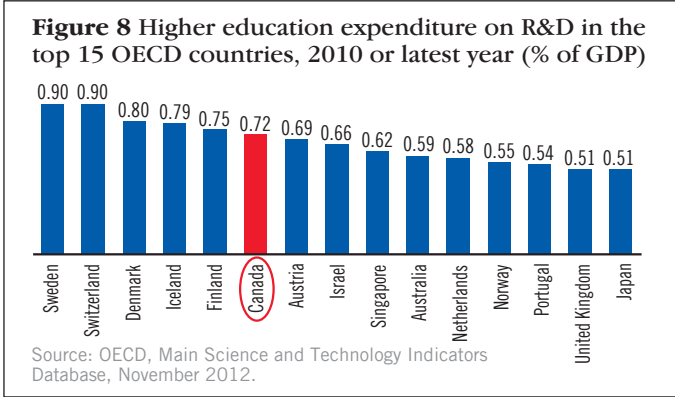
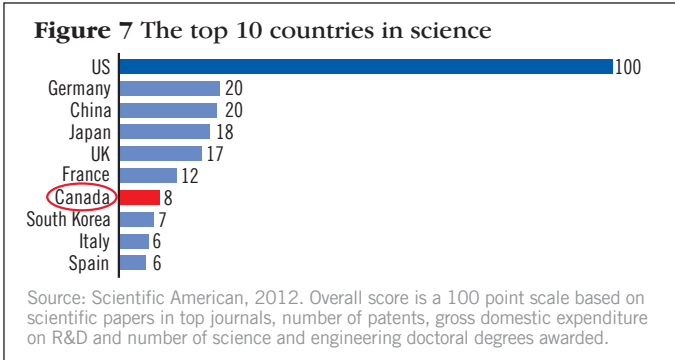
Sources: British Geological Survey, Forest Products Association of Canada, International Energy Association, USDA, Food and Agriculture Organization of the United Nations (2009).

These strengths aside, we continue to have innovation and productivity challenges. On the one hand, our university research capabilities are quite strong (figure 7) and our higher education expenditure on R&D as a percentage of GDP is first among G7 nations and high relative to most OECD countries (figure 8); however, we have poor innovation performance by the business sector, where Canada ranks 20th among OECD countries in business sector R&D spending as a percentage of GDP (figure 9). Canada needs a stronger focus on innovation to support competitiveness in this changing global economy.

While Canada trades with a broad group of countries, this trade is highly concentrated in the US and Europe, both of which face a slower growth future – OECD countries account for 89 percent of our exports. The response is relatively straightforward: we need to diversify. This means shifting more of our future trade towards a strategic set of dynamic emerging economies; it means focusing more on the new middle class in these emerging economies, not solely on selling them natural resources; and it means changing what we sell towards more innovative goods and services that rely on meeting emerging consumer needs at premium prices. The good news is that this picture is changing, but slowly. Between 2002 and 2011, Canada's exports to China increased by a compound annual growth rate of 16.9 percent, though on a small base – China still accounts for only 3.8 percent of Canadian exports (figure 10).

Canada ranks first among OECD countries in the proportion of adults with a college education (24 percent) and ranks eighth in the proportion of adults with a university education (26 percent). Canadian women, in particular, are relatively highly skilled; the proportion of women in Canada with some higher education credentials (55 percent) is larger than in any other OECD country.

In today's competitive global economy, Canada's workforce is educated, multilingual, and multicultural, representing a true competitive advantage. Many Canadians speak multiple languages – more than 200 languages were reported in the 2011 census as a mother tongue and 5.8 million people (17.5 percent of the population) reported speaking at least two languages at home. Canada ranks first among OECD countries in the proportion of adults with a college education (24 percent) and ranks eighth in the proportion of adults with a university education (26 percent). Canadian women, in particular, are relatively highly skilled; the proportion of women in Canada with some higher education credentials (55 percent) is larger than in any other OECD country.



Canada's public education system is strong. On standardized reading, scientific, and mathematical literacy scales, Canada ranks third, second, and fifth, respectively among OECD countries – and well ahead of the US (figure 11). In the most recent QS World University Rankings, Canada has two universities in the top 20 (McGill and University of Toronto).

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An important factor for attracting and retaining global talent is the community environment that a country can offer. In a recent *Economist* survey, three Canadian cities were among the world's top five most liveable cities, a list from which American cities are noticeably absent (figure 12).

As the global financial crisis so aptly demonstrated, solid financial systems matter dearly to economies. For the fifth consecutive year, the World Economic Forum has ranked Canada as having the soundest financial system in the world. The top six safest banks in North America are all Canadian (figure 13). And, safety and soundness pay off; today, five of the major Canadian banks rank among the top 10 financial institutions in North America based on market capitalization and asset size (figures 14 and 15).

In times of uncertainty, institutional strength and rule of law are important for foreign investment and partnership because they instill confidence in a country's long-term sustainable performance. The World Economic Forum ranks the quality of Canada's institutions (in their terms, "the legal and administrative framework within which individuals, firms, and

Figure 11 G7 countries ranked (out of 32 OECD countries) by student mean score on the reading, scientific, and mathematical literacy scales, 2006

Country	Ranking		
	Reading	Science	Math
Canada	3rd	2nd	5th
France	17th	19th	17th
Germany	14th	8th	14th
Italy	24th	27th	28th
Japan	12th	3rd	16th
UK	13th	9th	18th
US	32nd	21st	26th

Source: OECD Education at a Glance, 2009.

Figure 12 The world's most liveable cities, 2012

City	Country
1. Melbourne	Australia
2. Vienna	Austria
3. Vancouver	Canada
4. Toronto	Canada
5. (tie) Calgary	Canada
5. (tie) Adelaide	Australia
7. Sydney	Australia
8. Helsinki	Finland
9. Perth	Australia
10. Auckland	New Zealand

Source: *Economist* Magazine, August 2012.

Figure 13 Top 10 safest banks in North America

Bank	Country
Royal Bank of Canada (RBC)	Canada
Toronto-Dominion Bank (TD Bank)	Canada
Scotiabank (Bank of Nova Scotia)	Canada
Caisse centrale Desjardins	Canada
Bank of Montreal (BMO)	Canada
Canadian Imperial Bank of Commerce (CIBC)	Canada
BNY Mellon	United States
CoBank ACB	United States
JPMorgan Chase	United States
National Bank of Canada	Canada

Source: *Global Finance* Magazine August 16, 2012.

Figure 14 Top 10 North American banks ranked by market cap (\$ US billions)

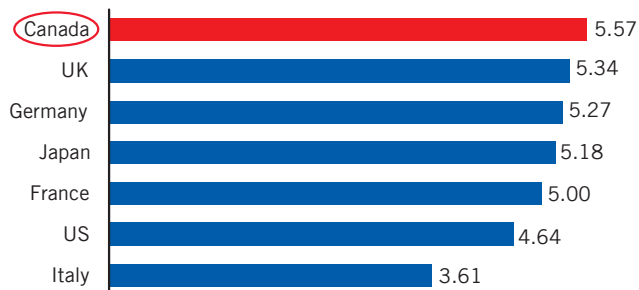
	Company	Market Cap	Country
1	Wells Fargo & Co	182.0	United States
2	JPMorgan Chase	161.9	United States
3	Citigroup Inc.	110.1	United States
4	Bank of America	102.4	United States
5	Royal Bank of Canada	84.3	Canada
6	Toronto-Dominion Bank	75.5	Canada
7	US Bancorp	64.6	United States
8	Bank of Nova Scotia	63.8	Canada
9	Bank of Montreal	38.8	Canada
10	Canadian Imperial Bank of Commerce	31.5	Canada

Figure 15 Top 10 North American banks ranked by asset size (\$ US billions)

	Company	Asset Size	Country
1	JPMorgan Chase	2321	United States
2	Bank of America	2166	United States
3	Citigroup Inc.	1931	United States
4	Wells Fargo & Co	1375	United States
5	Royal Bank of Canada	824	Canada
6	Toronto-Dominion Bank	806	Canada
7	Bank of Nova Scotia	670	Canada
8	Bank of Montreal	542	Canada
9	Canadian Imperial Bank of Commerce	401	Canada
10	US Bancorp	352	United States

Source: Bloomberg, October 2012.

Figure 16 Quality of institutions ranking (global competitiveness index), 2011-12, G7 countries



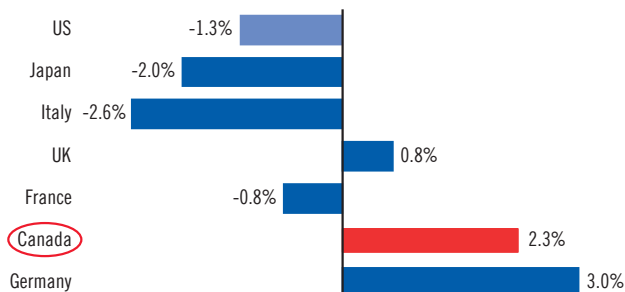
Source: World Economic Forum Global Competitive Index 2011-2012.

Figure 17 World Justice Project (WJP) Rule of Law Index Factor ranking among G7 countries and globally

Rule of Law Index Factors	Canada Ranking among G7 Countries*
Limited Government Powers	2nd (7)
Absence of Corruption	2nd (11)
Fundamental Rights	3rd (14)
Open Government	2nd (6)
Regulatory Enforcement	4th (13)
Access to Civil Justice	4th (16)
Effective Criminal Justice	2nd (10)
Average for All Factors	3rd (11)

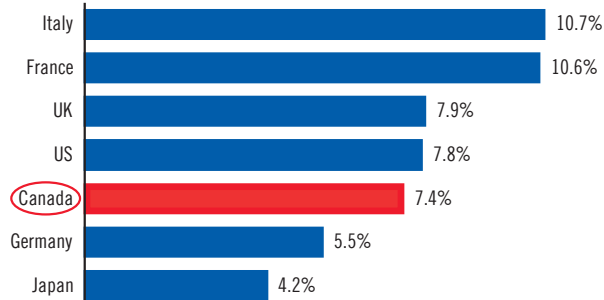
*Canadian global ranking among 66 countries shown in parenthesis.
Source: World Justice Project Rule of Law Index, 2011.

Figure 18 Change in employment, G7 countries, October 2008 - October 2012



Source: Stats Canada, October 2012.

Figure 19 Unemployment rate, G7 countries, October 2012



Source: Stats Canada, October 19, 2012.

Figure 20 Real GDP growth in G7 countries, 1999-2013


	Canada	US	Germany	France	Italy	UK	Japan
Average 1999-2008	2.9	2.5	1.6	2.0	1.2	2.5	1.3
2009	-2.8	-3.1	-5.1	-3.1	-5.5	-4.0	-5.5
2010	3.2	2.4	4.0	1.7	1.8	1.8	4.5
2011	2.4	1.8	3.1	1.7	0.4	0.8	-0.8
2012 (f)	1.9	2.2	0.9	0.1	-2.3	-0.4	2.2
2013 (f)	2.0	2.1	0.9	0.4	-0.7	1.1	1.2

Source: IMF WEO, October 2012.

governments interact to generate wealth”) the highest of the G7 (figure 16). As well, Canada ranks second or third in the G7 on most World Justice Project (WJP) Rule of Law Index Factors rankings, well ahead of the US (figure 17).

These solid fundamentals are reflected in a strong overall economy. Canada has a lower unemployment rate than most G7 nations and is one of the few countries in this peer group to have experienced an increase in employment relative to pre-recession (figures 18 and 19). Growth projections for Canada by the IMF and OECD for 2012-2013 continue to be among the strongest in the G7 (figure 20).

All good, but we need to be at the forefront of the new global competitiveness. The old competitiveness was, quite simply, how do I produce a good more cheaply than my competitor? That’s no longer feasible, because it is an endless race to cut costs, and unless you have enormous scale or market power, it’s very tough to win. The new competitiveness is quite different: it’s about our innovation capacity, our talent, and our global perspective. That perspective needs to be endlessly focused on excellence, and relentlessly worldwide in scope – understanding that your next big opportunity, competitor, partner, or new idea could come from anywhere in the world. At its heart the new competitiveness is about innovation, and the fabric that propels it – the quality of our workforce, the excellence of our researchers, the entrepreneurship of our business sector, the quality of our public servants, the dedication of our educators.

As we face a global future that will be volatile, uncertain, and profoundly changing, we can take pride in the solid strengths that comprise Canada. But we must not be complacent. The status quo is not a viable strategy in a profoundly changing world. We need to address our low productivity growth and innovation performance. We need to expand our talent pool. We need to focus on emerging markets in this new globally competitive world. We need to build upon our strengths and not rest on them. 

Contributing Writer Kevin Lynch is Vice Chair, BMO Financial Group and Former Clerk of the Privy Council and Secretary to the Cabinet. Karen Miske is Senior Advisor, Office of the Vice Chair, BMO Financial Group.