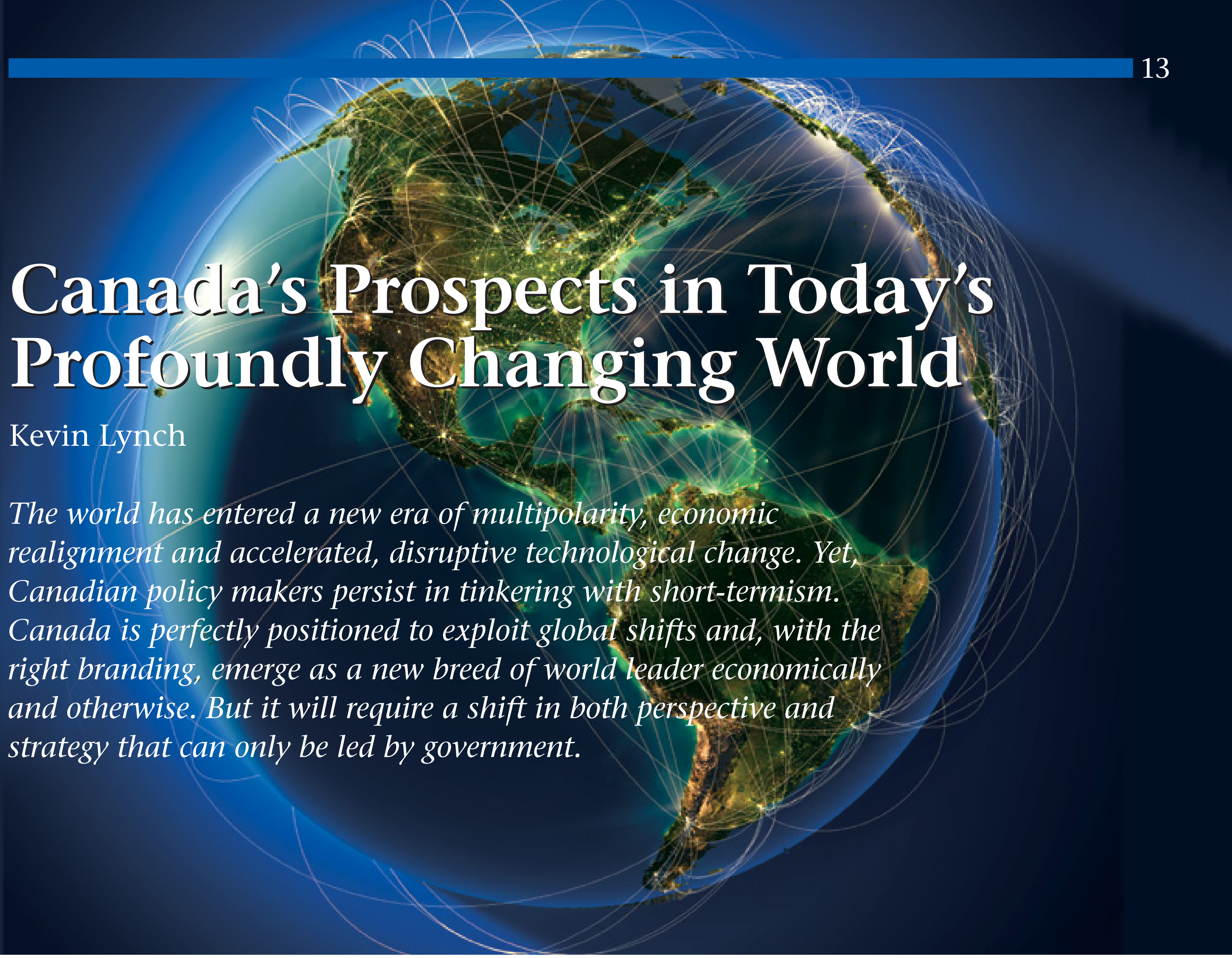


Canada's Prospects in Today's Profoundly Changing World

Kevin Lynch

The world has entered a new era of multipolarity, economic realignment and accelerated, disruptive technological change. Yet, Canadian policy makers persist in tinkering with short-termism. Canada is perfectly positioned to exploit global shifts and, with the right branding, emerge as a new breed of world leader economically and otherwise. But it will require a shift in both perspective and strategy that can only be led by government.

Why is Canada seemingly trapped in an incrementalist mindset in our public policy thinking? It cannot be explained by the world around us, which is anything but static, or even terribly predictable. It is certainly not explainable by technology trends, which appear poised for another inflection point and promise a new technological revolution. And it is definitely not reflective of the absence of either great opportunities or great challenges, as both are beckoning. Rather, Canadian policy makers appear mired somewhere between a great complacency and a great fixation on the short term, neither of which is conducive to policy innovation or long-term thinking.

And yet the need for new thinking to respond to novel circumstances, both local and global, seems glaringly self-evident. The world is well launched towards a new global normal, which will be quite different than the western economic pre-eminence of the postwar period. A multi-polar world is emerging, where economic power is being dramatically redistributed, and geopolitical power will eventually follow. The centre of international economic gravity is shifting to China and Asia, after a hiatus of four centuries. The demographics of aging are reshaping labour markets and putting new pressures on social systems in many countries, including China. The information revolution is transforming just about everything—how we work, how we communicate, how we interact.

In short, the status quo is being rudely cast aside, but nonetheless we tinker. Where is the bold thinking to diversify our trade, energy and investment markets? To tackle our innovation and productivity deficits? To build our human capital advantage in a demographically challenged world? To mobilize public and private capital for competitiveness-enhancing infrastructure? To unite technology and policy for better environmental outcomes?

The irony is that Canada is so well placed to prosper in this new global normal, provided that we act, not react, in the face of the momentous global changes underway; that we adapt, adroitly and quickly, to the new opportunities and old challenges, not be a distant follower; and that we adopt a longer term perspective, not continue to be seduced by the tyranny of short-termism.

So what will this take?

Above all, vision, leadership and a willingness to be a policy innovator. What follows are 10 observations on Canada's potential in this profoundly changing world. They range from attitudes, to education, to fiscal frameworks, to natural resources, to productivity, to income mobility and equality, and beyond. If the list sounds eclectic, it both is and is not: success in this new global normal is complex, redefines traditional measures of competitiveness, and erases easy distinctions between what is economic policy and what is social policy.

Observation 1: Attitudes matter (Chart 1A and 1B).

Trust, a central banker once quipped, arrives on foot and leaves in a Ferrari. The global financial crisis certainly sent the Ferraris racing. But so have other events such as environment disasters, corporate governance fiascos, privacy breaches in government and companies, political improprieties, etc. The cumulative impact has been a substantial decline in public trust in leadership, both public and private, in many countries and across many sectors of the economy. The consequence of diminished trust is a diminished ability to mobilize publics for change, whether by a corporation or a government.

The world is well launched towards a new global normal, which will be quite different than the western economic pre-eminence of the postwar period.

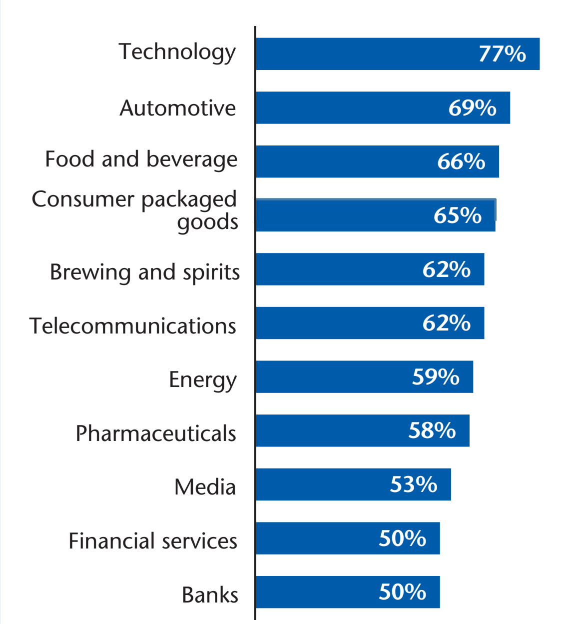
According to the Edelman Global Trust Barometer, techies have replaced bankers as the trusted masters of the universe. Last year, on the Global Trust Barometer, only about 43 per cent of Americans professed to trust the US financial system, whereas a majority of Canadians did so and Asia topped the charts for trust in their financial systems.

What about differences in a broader range of attitudes beyond trust? The Pew Research Institute conducts attitudinal surveys on a variety of issues around the world. As a 2013 Pew Research Global Attitudes Survey noted, North America is a tale of one continent but two very distinct public moods. Pew found that: "by almost every measure, publics in Canada and the United States see the world they are experiencing through different lenses."

Canada has demonstrated a capacity to forge a different policy path than its giant southern neighbour—be it in financial sector regulation, fiscal policy, public pensions, health care, or tax policy, to name a few. These have reshaped relative public moods and influenced relative economic performance. Too often, when the rest of the world looks to North America, it only sees the enormous size of the US market and the US-Canada similarities, not the differences in approach and potential.

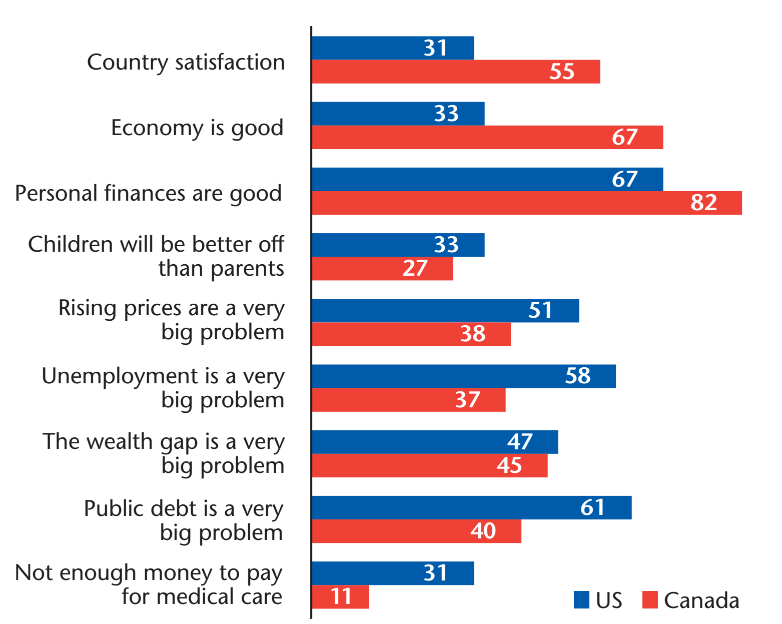
Canada has considerable under-realized global brand potential, and this comes at a cost: to our firms in selling abroad, to attracting foreign investment, to interesting the best and

CHART 1A: The 2013 Edelman Global Trust Barometer



Source: Edelman

CHART 1B: Pew Research 2013 Attitudes Survey: The North American Divide (% agreement with statement)



Source: Pew Research

brightest students to study here, and to encouraging entrepreneurs to emigrate here.

Observation 2: A new two-speed world (Chart 2).

The global "macroeconomic" context is structurally changing. A two-speed world is rapidly emerging, with the advanced economies moving into the slow lane, as aging demographics and slowing productivity take their toll, and the dynamic emerging market economies now leading global growth, driven by globalization, urbanization, demographics and the information revolution.

In this shifting environment, Canada has fared relatively well to date due to a number of global strengths, particularly our abundant natural resources, healthy public finances, and a strong financial sector. But going forward, with global growth shifting ever more from the OECD countries to the emerging markets in Asia and elsewhere, Canada, with 89 per cent of its trade today with "slow growth economies", faces an imperative to diversify our trade in order to expand export-oriented growth in the future.

According to the Edelman Global Trust Barometer, techies have replaced bankers as the trusted masters of the universe. Last year, on the Global Trust Barometer, only about 43 per cent of Americans professed to trust the US financial system, whereas a majority of Canadians did so.

Observation 3: Fiscal sovereignty (Chart 3).

Fiscally, things really are different today across most OECD countries. The US government net debt-to-GDP ratio, at 87 per cent, is in territory that it last explored just after the Second World War, and debt-to-GDP ratios are well above the Maastricht upper levels of 60 per cent of GDP in most EU countries. The global financial crisis has had a severe impact on government debt levels, particularly in countries where there were banking failures.

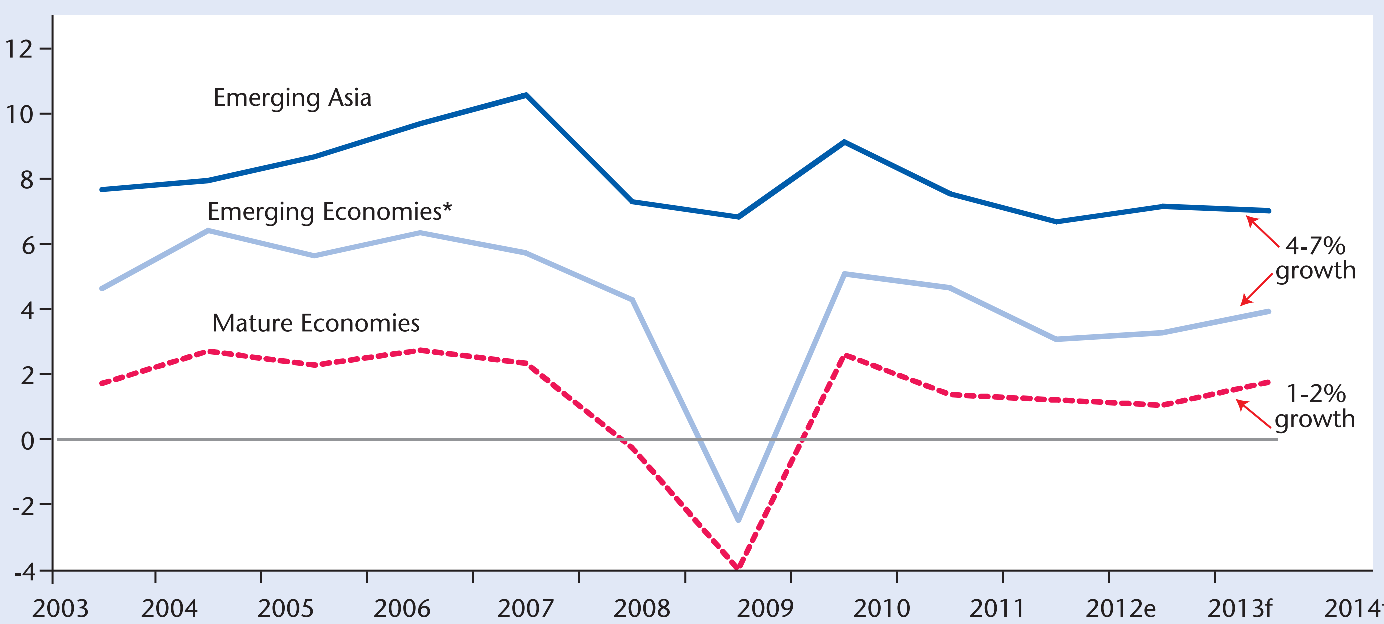
The exceptions to this recent trend are the Nordic countries, Canada, Australia and New Zealand, with net government debt-to-GDP ratios ranging from 36 per cent in Canada to roughly 0 per cent in Sweden. Canada and several other countries also have actuarially funded national pension plans. Relatively low government debt-to-GDP levels avoid crowding out of private sector debt, provide "national insurance" in an uncertain and volatile world, and create the capacity to act in support of national priorities.

Observation 4: Emerging markets growth = demand for natural resources (Chart 4).

The emerging market economies now leading global growth are in need of energy and natural resources to fuel that growth. With ballooning middle classes, they are also in need of agricultural resources and value-added foodstuffs.

Canada is in the enviable position of being a dominant producer of most natural resources. Canada is a major energy producer with the third largest oil reserves in the world. It is the fourth largest producer of gas and

CHART 2: Two Speed World: The Visual



e = estimate, f = IIF forecast, *Excluding Asia

Source: IIF Capital Flows to Emerging Market Economies, Jan 22, 2013

Canada is in the enviable position of being a dominant producer of most natural resources. Canada is a major energy producer with the third largest oil reserves in the world. It is the fourth largest producer of gas and the sixth largest global producer of oil.

the sixth largest global producer of oil. Today, Canada is the largest exporter of energy to the US. Canada is also a prominent global agricultural producer.

Clearly, as world demand for natural resources grows, spurred by rapid Asian expansion, this will benefit resource-rich countries like Canada. While the potential is evident, the challenges for Canada are also clear. We need to invest more in research and innovation to improve the productivity of how we develop and produce these resources; we need to invest in the transportation infrastructure to service these new regions efficiently; and, we need to develop the distribution partnerships abroad to bring our resources and foodstuffs to market.

Observation 5: Energy revolution (Chart 5).

We are in the midst of an energy revolution, in both demand and supply. Demand, which will rise over 30 per cent between 2010 and 2035, is shifting from the OECD countries to the rapidly growing emerging economies. Indeed, 97 per cent of energy demand growth will come from non-OECD countries, a dramatic reversal of past energy growth trends. Reflecting energy efficiency gains, energy substitutions and lower potential growth, there will be no growth in US energy demand, a major risk for Canada, which exports 100 per cent of its oil and gas to the American market.

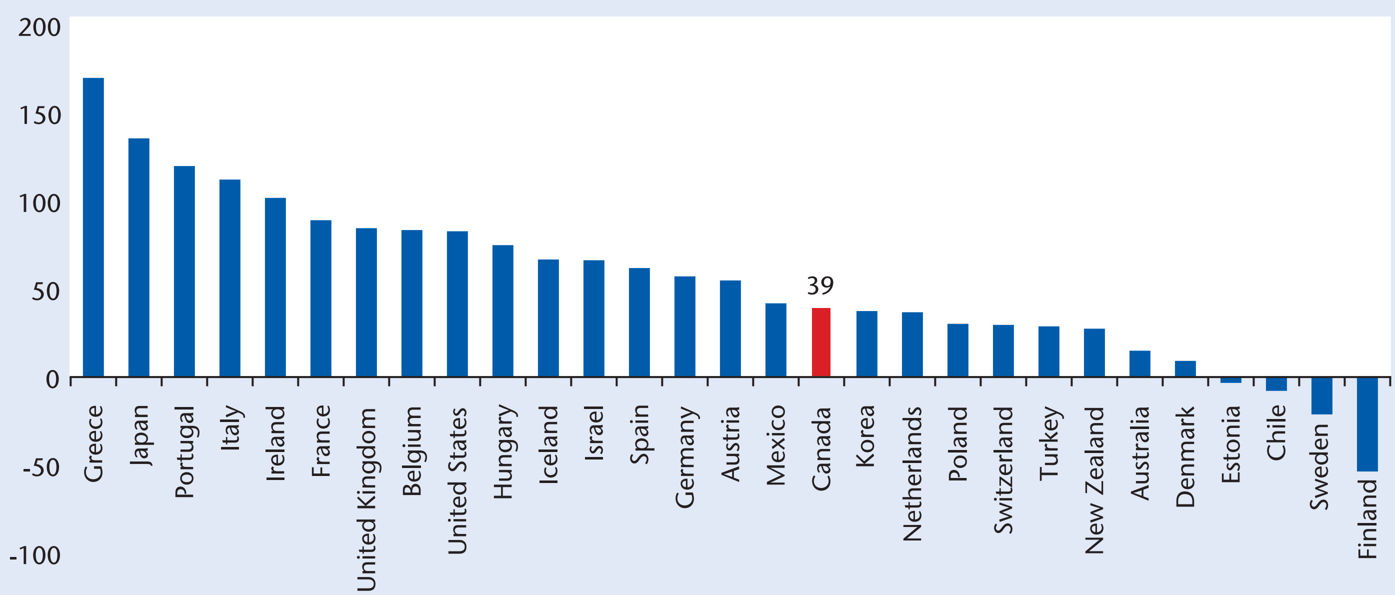
CHART 4: Canada's Energy and Natural Resource Ranking

ENERGY AND NATURAL RESOURCES	RANKING
Uranium	2nd
Hydro	3rd
Natural Gas	4th
Crude Petroleum	6th
Potash	1st
Titanium	1st
Aluminum	3rd
Tungsten	3rd
Diamond	4th
Nickel	5th
Platinium Group	5th
Molybdenum	6th
Zinc	6th
Gold	8th

RESERVES
Large shale gas reserves
3rd largest oil reserves in world (oil sands)

Sources: Canadian Minerals Yearbook, US Geological Survey (USGS), Food and agriculture organization of the United Nations (FAOSTAT)* latest year, IEA, British Geological Survey, Forest Products Association of Canada, International Energy Association

CHART 3: 2013 General Government Net Debt, OECD Countries (% of GDP)



Source: IMF World Economic Outlook, April 2014
Note: Portrays general government net lending and general government net debt for all levels of government

Supply is shifting dramatically to "unconventional" sources—oil sands, shale oil, shale gas, etc. The advent of shale gas and oil is moving the US into net energy self-sufficiency, another major risk for Canada's energy sector.

Canada has abundant "unconventional energy supply" potential, but it is "trapped" in a North American market with excess supply and little demand growth. The impacts are threefold: Canadian oil sells at a substantial discount into traditional American markets (an average discount of $23 in 2013 with peaks over $40); incremental Canadian oil and gas supply does not have security of demand in the US; and, Canadian and American gas sells well below prices in either Asia or Europe. The simple answer to these three impacts is: diversification.

To expand Canada's unconventional oil supply capacity will require oil exports to new markets in Asia and elsewhere, and this needs energy transportation infrastructure to tidewater, either on the west or east coasts. Similarly, to expand gas exports and raise net gas prices will require LNG exports to either Asia or Europe, and this too needs pipelines and LNG facilities. The potential is enormous, but the transportation hurdles must be overcome and there is a limited window of time to tap these new markets as competition is fierce, including from the United States.

CHART 5: Canada's Energy Exports to the US and a Comparison of LNG Pricing

CANADIAN ENERGY OPPORTUNITIES AND RISKS

CANADA'S ENERGY EXPORTS TO US, 2010 %, BY VALUE	
Crude Oil (including Oil Sands)	99.50%
Hydro	99.20%
Natural Gas	100%

NATURAL GAS GLOBAL PRICING 2013 AVERAGE (US$/MMBTU)	
North America (HH)	3.89
Japan/South Korea (JKM)	16.56
Europe (Netherlands TTF)	10.38
UK (NBP)	10.35

As of Feb 13, 2014

CHART 6: World Economic Forum Rankings: Soundness of Banks 2013-14

TOP 10

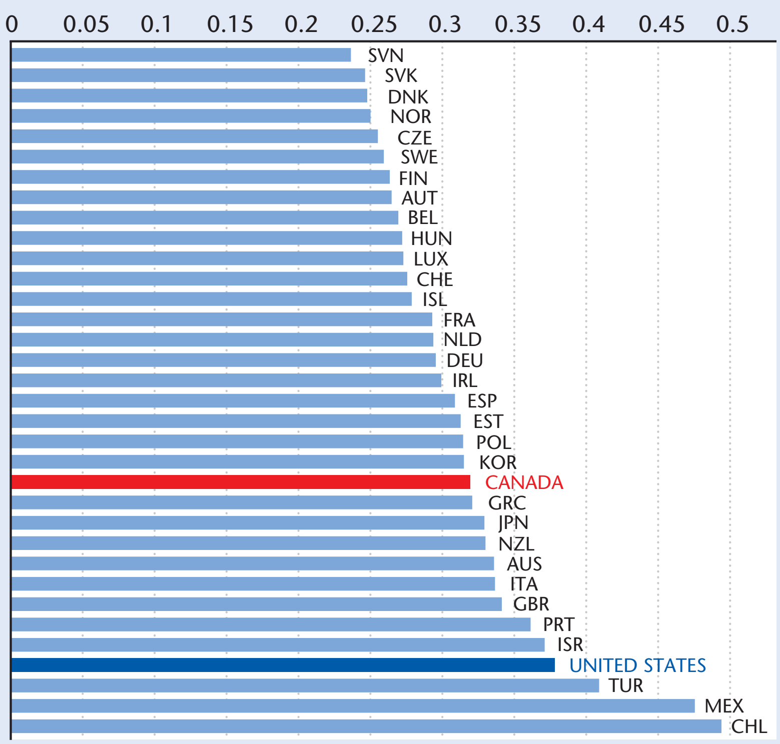
RANK	COUNTRY
1	Canada
2	New Zealand
3	South Africa
4	Hong Kong SAR
5	Singapore
6	Finland
7	Panama
8	Norway
9	Australia
10	Chile

OTHER SELECT COUNTRIES

RANK	COUNTRY
12	Brazil
43	Japan
58	United States
62	France
64	Germany
72	China
88	Italy
105	United Kingdom

Source: World Economic Forum

CHART 7: Measure of income inequality (Gini coefficient) in OECD countries, late 2000s (a lower number indicates greater income equality)



Source: OECD

Observation 6: Institutional frameworks matter (Chart 6).

Macro frameworks matter greatly to economic outcomes, as the global financial crisis demonstrated once again. Effective frameworks positively influence market confidence, they lower perceptions of systemic risk, they improve public trust, and they support long-term economic growth.

Canada has a banking system ranked first in the world for safety and soundness, an efficient central bank with a clearly defined inflation target and a track record of success in hitting it, an effective financial sector regulatory system, and world class financial institutions. It taxes corporations at a much lower rate than the US, thereby creating an incentive for firms to operate in and from Canada.

However, in a world where trade often follows investment linkages, it has made a rules-based foreign investment regime much more discretionary and unpredictable, and thus relatively less attractive to needed capital flows. Canada should consider focusing more on the behaviour of capital and less on its ownership, and shift from increasingly arbitrary ownership rules to effective regulation geared to transparent objectives.

Observation 7: Where economic and social policy converge (Chart 7).

Sustained competitiveness and dynamic societies typically go hand-in-hand over the long haul. For a country to be competitive and resilient, wealth accumulation and wealth distribution both matter. Sustainable competitiveness requires dynamic societies, with equality of opportunity, upward mobility, and dispersion of income. Thus, rising income inequality and declining economic mobility in many countries should be a worrisome trend for policy makers and markets.

Today, rising income inequality is becoming an economic, social and political issue for a number of countries, both developed and developing. While income inequality has increased in Canada, it has not changed much over the last decade. Moreover, it is better than in most G7 countries, particularly the US, on the basis of standard Gini coefficients or ratios of high income to low income earners. The challenge for Canada is not to ignore the implications of income inequality and economic mobility, but to deal with our specific issues, and not mistakenly import those of others.

Observation 8: Competitiveness is complex and changing (Chart 8).

The "competitiveness context" for all countries and sectors is changing. While competitiveness is complex and varies across countries and industrial mixes, for high income-high

CHART 8: The Competitiveness Context

Rankings	Global Competitiveness Index (WEF)	Global Opportunity Index (FDI) (Milken)	Soundness of Financial Systems (WEF)	Net Debt to GDP, 2013 (IMF) (Lowest to highest)	Tertiary Education, % of Population (OECD)	K-12 Pisa Results: Math (OECD)	Innovation Capacity (WEF)	Number of Universities in Top 10 (Times Higher Education)	Ranking of Cities—EIU Global Liveability (# of cities in top 10; ties settled based on rankings)
#1	Switzerland	Hong Kong	Canada	Norway	Canada	China (Shanghai)	Switzerland	United States	Australia
#2	Singapore	Singapore	New Zealand	Finland	Japan	Singapore	Finland	United Kingdom	Canada
#3	Finland	Denmark	South Africa	Sweden	United States	Hong Kong	Germany	Germany	Austria
#4	Germany	Canada	Hong Kong	Chile	New Zealand	Taipei	Israel	Netherlands	Finland
#5	United States	United Kingdom	Singapore	Estonia	Finland	Korea	United States	Australia	New Zealand
Canada	14th	4th	1st	14th	1st	13th	27th	6th	2nd
United States	5th	22nd	>40th	22nd	3rd	36th	5th	1st	N/A

Sources: IMF, OECD, Milken, Times Higher Education, EIU cost economies today, there are several core drivers of competitiveness, with innovation, talent, frameworks, and entrepreneurship ranking near the top.

Looking at a variety (9) of competitiveness indicators across a wide range of countries, Chart 8 presents the top 5 countries on the basis of each measure, as well as the rankings for Canada and the US. What emerges is that size is not as much a determinant of competitiveness as is commonly supposed; indeed, nimbleness and innovation appear to be better enablers. The fundamentals, such as education, research capacity, quality of urban life, infrastructure, and frameworks like the rule of law, matter more than low labour costs.

On balance across these measures, except for innovation, Canada scores reasonably well. The question is whether "good" is good enough in today's hyper-connected and extremely competitive global economy.

Observation 9: The good, the bad and the ugly of Canada's competitiveness (Chart 9).

Pursuing this question of our competitiveness further, Chart 9 presents an admittedly qualitative snapshot of "the good, the bad and the ugly" of Canada's competitiveness scorecard. Canada has fared well over the last 15 years because of a number of strengths, and these we need to maintain and strengthen.

But our weaknesses are becoming increasingly evident and problematic in today's changing world, with economic growth shifting away from our traditional markets, with competitiveness increasingly driven by innovation not just input costs, and with talent and entrepreneurship more and more essential in a demographically challenged world. We must adapt to the new global reality with a greater trade orientation to emerging markets, with more business focus on innovation in products and services, and with a relentless quest for excellence in our education, research and training systems—improved global university rankings; higher PISA scores and better vocational training.

Observation 10: Diversification unlocks opportunities (Chart 10).

Canada has much to offer the large emerging market economies, and their ever-expanding middle classes, and Chart 10 provides an indicative matching of our potential and their needs.

But we will not fully realize these opportunities with our current, incremental approaches. Rather, diversification will be key, and this will take new thinking to seize these new opportunities.

Canada needs new thinking and clearer public strategies in areas such

CHART 9: Canada Relatively Speaking: the Good, the Bad and the Ugly

GOOD...	Solid economic fundamentals	Lowest net debt (to GDP) in G7; low inflation (2% over decade); actuarial sound national pension plan
	Strong human capital	1st in OECD for PSE education; multi-cultural workforce; Strong public university system; strong research capacity
	A sound financial system	WEF rates Canada 1st in world for soundness of banking system
	Robust natural resources (energy, minerals, agriculture)	Third largest oil reserves in world; major producer in most natural resource categories
	Solid institutions, safety nets, legal frameworks	Ranks first among G7 for quality of institutions; income inequality much less than US; multicultural society
BAD...	Canadian trade mainly with "slow growth" countries	89% of Canadian trade with OECD; China less than 5% of Canadian exports
	Population is aging	Canadian labour force growth slowing; immigration and education key
	Global education rankings	Only 4 universities in the top 100 world rankings (and 7-9 in top 200)
UGLY...	Business productivity growth is low	Canadian business productivity growth slowing (0.8% in 2000s), and levels are only 72% of US
	Business R&D spending is weak	Canadian business R&D spend 1% of GDP, (US is 2%), and we ranked 22nd ranked in OECD

Sources: IMF, OECD, Milken, Times Higher Education, EIU as energy and trade diversification. It requires trade and investment agreements with the key emerging market countries such as China, Brazil and India, and a "Canada brand" strategy in these new markets as our competitors aggressively deploy. It requires new infrastructure to facilitate these changing trade patterns, and new FDI links to build the commercial and distribution partnerships.

Last word: New thinking for these new opportunities.

In this changing world, to realize the full potential of "Advantage Canada", we must think more globally, plan more long-term, and create more of a sense of urgency to turn our potential into the firms, jobs, growth and wealth that will provide the next generation of well-educated Canadians with good jobs and a rising standard of living in an ever more competitive global marketplace.

- We need to avoid "parochialism"—individuals, companies, universities, countries need clear "going global" strategies, understood by all, because that's where their markets are, their competitors, their partners, their students—their future.
- We all need to avoid "status quo-ism"—in a profoundly changing world, the status quo is not a long term strategy for success. To compete, innovation and productivity need to be part of our structures, our DNA.
- We all need to avoid "silo-ism"—in a multi-sector world, we need to understand all sectors, not just our own: those who work well across sectors often are most transformative in the longer term.
- We all need to avoid "short term-ism"—it is hard to build for the future with a quarterly mindset and without a longer term strategic focus. To paraphrase Tom Friedman, if strategy were a sport, it would be a marathon, over and over and over again. P

Contributing Writer Kevin Lynch is Vice Chair, BMO Financial Group, and a former clerk of the Privy Council.

CHART 10: Canada's Relative Global Strengths and Opportunities

CANADA'S RELATIVE GLOBAL STRENGTHS
Solid economic fundamentals, including low inflation, fiscal probity and low corporate taxes Lowest net debt (to GDP) in G7; Corporate tax rate 9 pp below US
Strong human capital Workforce is highly skilled, multicultural and multilingual
Robust natural resources (energy, minerals, agriculture) Major producer in most natural resource categories
A sound financial system Rated 1st in world for sound banking system
Good public education system 1st in OECD for PSE education; World class university research capacity
Strong institutions, rule of law, civic values Canada 1st in G7 for quality of institutions (GCI)

EMERGING MARKET OPPORTUNITIES
Natural Resources 30% increase in global energy demand, China and India accounting for 50% of this
Infrastructure and Housing 27T expected infrastructure spend in emerging Asia alone; large requirements in South America
Financial Services Wealth management, asset management, pensions and insurance
Agriculture and Food With 800-900 million new middle class in Emerging Markets, doubling by end of decade, enormous increase in demand for higher value added foods
Tourism 110 million outbound Chinese travelers in 2015; strong growth elsewhere in Asia and South America
Education Huge need to educate youth in Brazil, China, India, elsewhere. Estimates of 1B+ youth to educate in any given year
Healthcare Spending to triple in Asia alone by 2020; large increases in South America