



# Crystal Ball Report

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Business Strategies for Uncertain Times  
Economic and Political Outlook for 2018



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## Executive Summary

Canadian companies will see domestic and international business conditions change in some fundamental ways over the next five years. Some trends are already apparent. In many other cases, drivers of change can be identified but their outcomes remain highly uncertain. Change brings challenges, but also heralds new opportunities for those businesses that look ahead, have appropriate risk management systems in place, and continue to invest in the people and capital required to deliver customer solutions.

Many of the risks that lie ahead for Canadian business reflect a high level of uncertainty about where the economy is heading. It has been a decade since the financial crisis and Great Recession, and the global economy is still in fragile condition. 2017 was the first year when anyone could speak in terms of a general recovery.

Economic activity is picking up in most major markets and central banks are beginning to raise interest rates, tightening credit conditions in the expectation of mounting inflationary pressures. Normally, that should be good news. However, the imbalances created by policy responses to the recession remain a significant threat to sustained economic growth. It may not take much tightening to tip highly indebted economies like Canada's back into low gear.

Economic uncertainties are being compounded by rising levels of political risk. Growing protectionism in the United States and other countries threaten the resilience of international trade flows and the competitiveness of supply chains upon which the growth of the global economy – and the Canadian economy in particular – depend. The future of the multilateral institutions that have guided the world economy and international political relations over the past 80 years can no longer be taken for granted. And, geo-political risks are greater than at any time since the depth of the Cold War.

Markets and business models are also being disrupted. New opportunities are opening up with the growth of middle class consumer markets around the world. Global challenges like climate change and environmental sustainability, the secure and sustainable supply of food, water, energy, and other natural resources, the impact of ageing populations, and threats to physical and cyber-security are demanding new innovative solutions. The expectations of customers, employees, stakeholders, and governments are changing. They are becoming more demanding than ever before. Competitive pressures are intense and decision-making timelines are being drastically compressed. The rapid pace of technological change is accelerating these trends, disrupting patterns of market supply and demand, giving rise to new solutions and brand new industries, while at the same time transforming the nature of work, requiring new types of business management and workforce skills, and transforming entire industries and supply chains.

## A Tenuous Economic Recovery

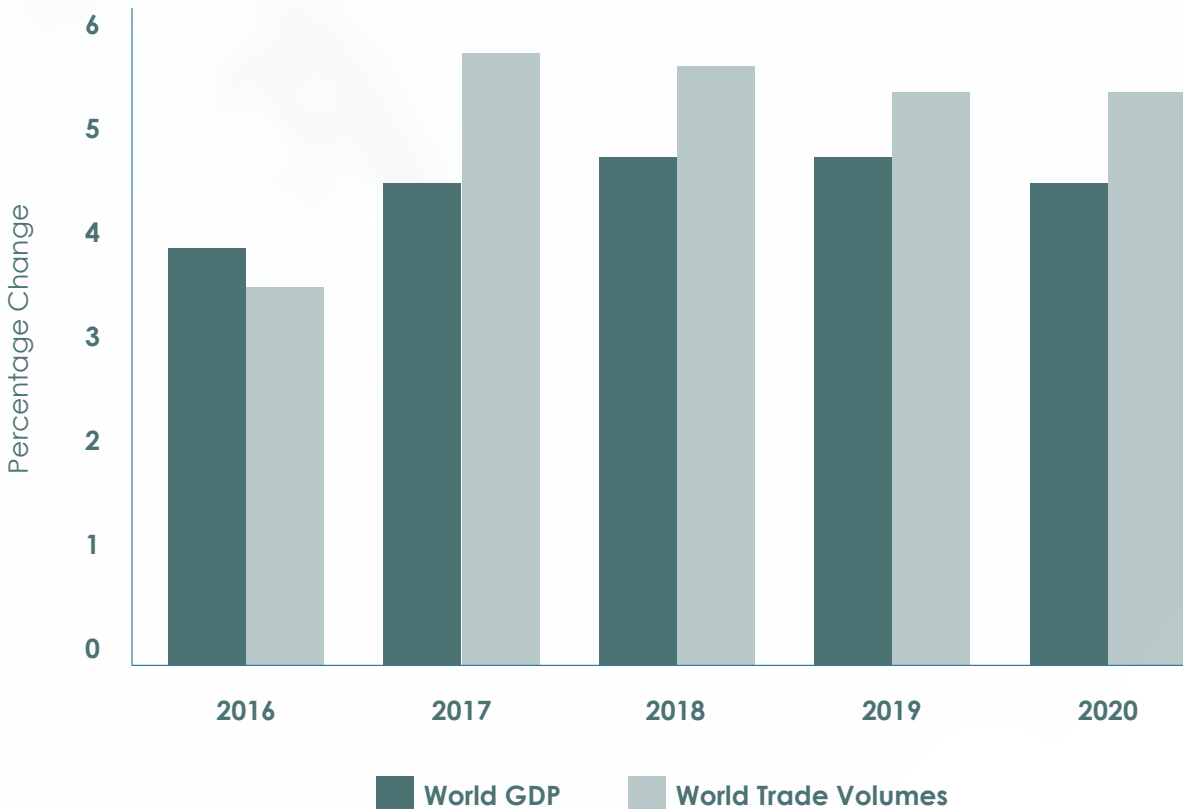
The global economy grew by an estimated 3.7% in 2017, its strongest rate of expansion in ten years. World trade flows increased by 4.3% on the back of stronger manufacturing growth and business investment.

Last year 120 countries, accounting for more than three-quarters of the world's Gross Domestic Product, saw a pick-up in economic activity. As the International Monetary Fund notes, it was the broadest synchronized upsurge in economic growth the world had seen since 2010. The economic rebound was evident in all major

national economies. It was especially strong in Asia, but growth rates exceeded expectations even in European and South American economies that had been slow to recover from the 2008-09 recession. Most economic forecasts are now predicting that the world economy will continue to expand at or near its currently healthy rate of growth at least over the next three years.

Nevertheless, virtually all economic forecasts point to significant economic and political risks that could jeopardize the broadly based global recovery. The World Bank's Global Economic Prospects report published in January 2018 says it best. Its subtitle simply reads "Broad-Based Upturn, but for How Long?"

Projected Growth in the World Economy and Trade Flows



Source: IMF

## IMF Outlook for Economic Growth, January 2018

	2016 (Actual)	2017 (Estimate)	2018 (Forecast)	2019 (Forecast)
World Output	3.2%	3.7%	3.9%	3.9%
Canada	1.4%	3.0%	2.3%	2.0%
United States	1.5%	2.3%	2.7%	2.5%
Euro Area	1.8%	2.4%	2.2%	2.0%
United Kingdom	1.9%	1.7%	1.5%	1.5%
Japan	0.9%	1.8%	1.2%	0.9%
China	6.7%	6.8%	6.6%	6.4%
India	7.1%	6.7%	7.4%	7.8%
Southeast Asia	4.9%	5.3%	5.3%	5.3%
Brazil	-3.5%	1.1%	1.9%	2.1%
Mexico	2.9%	2.0%	2.3%	3.0%
Middle East & North Africa	4.9%	2.5%	3.6%	3.5%
Sub-Saharan Africa	1.4%	2.7%	3.3%	3.5%

## Managing Imbalances

Governments and central banks around the world responded to the financial crisis and ensuing recession of 2008 and 2009 in similar ways – by dramatically loosening monetary and credit conditions, pumping liquidity into financial markets, rapidly lowering interest rates, and running stimulative fiscal policies. These measures had their desired effect. Borrowing on the part of households, businesses, and governments increased significantly. But, it has taken time for that borrowing to make its way into the real economy. Only now are we seeing real demand for goods and services strengthening to a point when central banks can begin to return monetary and credit market policies to a more neutral position.

The problem is that a number of financial and economic imbalances have been created along the way that will make the job of

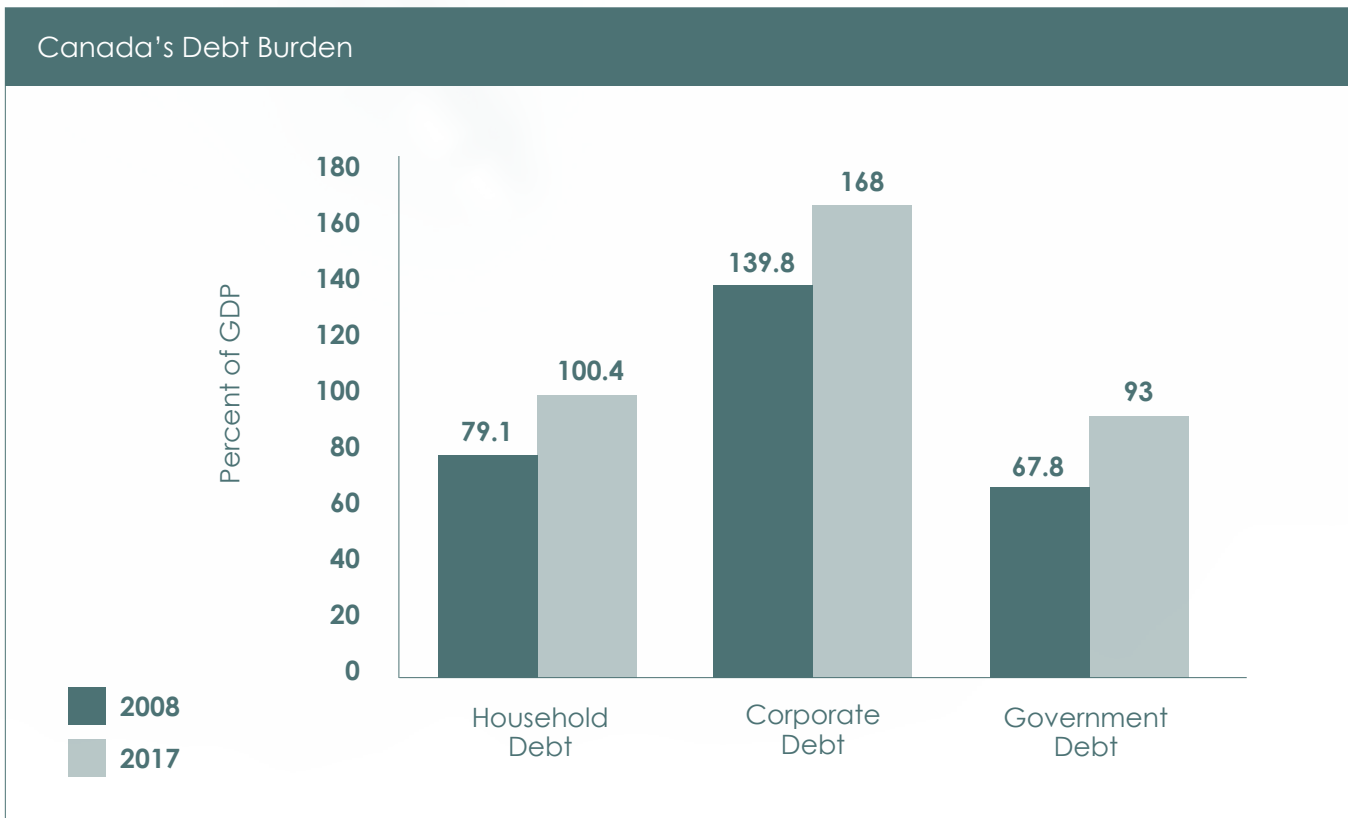
transitioning to more normal monetary conditions extremely challenging:

- The infusion of liquidity into capital markets has led to financial inflation, rapid increases and greater volatility in asset prices, and the risk of asset bubbles leading to shocks affecting the real economy of goods, services, and business investment. The world weathered the surge and then rapid deflation of oil and other commodity markets, but not without widespread damage to resource-based economies like Canada's. Currency markets continue to be highly volatile. Likewise, the inflation of property prices and real estate markets, the rapid run-up in equity markets around the world even as earnings performance has

lagged behind, and the effervescent demand and increasingly volatile trading of technology stocks are all signs of excess liquidity in financial markets. It is highly unlikely that financial market volatility will calm down as central banks tighten credit conditions – just the opposite; forecasters are pointing to heightened risks of asset market corrections with the fall-out on personal wealth and balance sheets aggravating negative impacts on real economic performance.

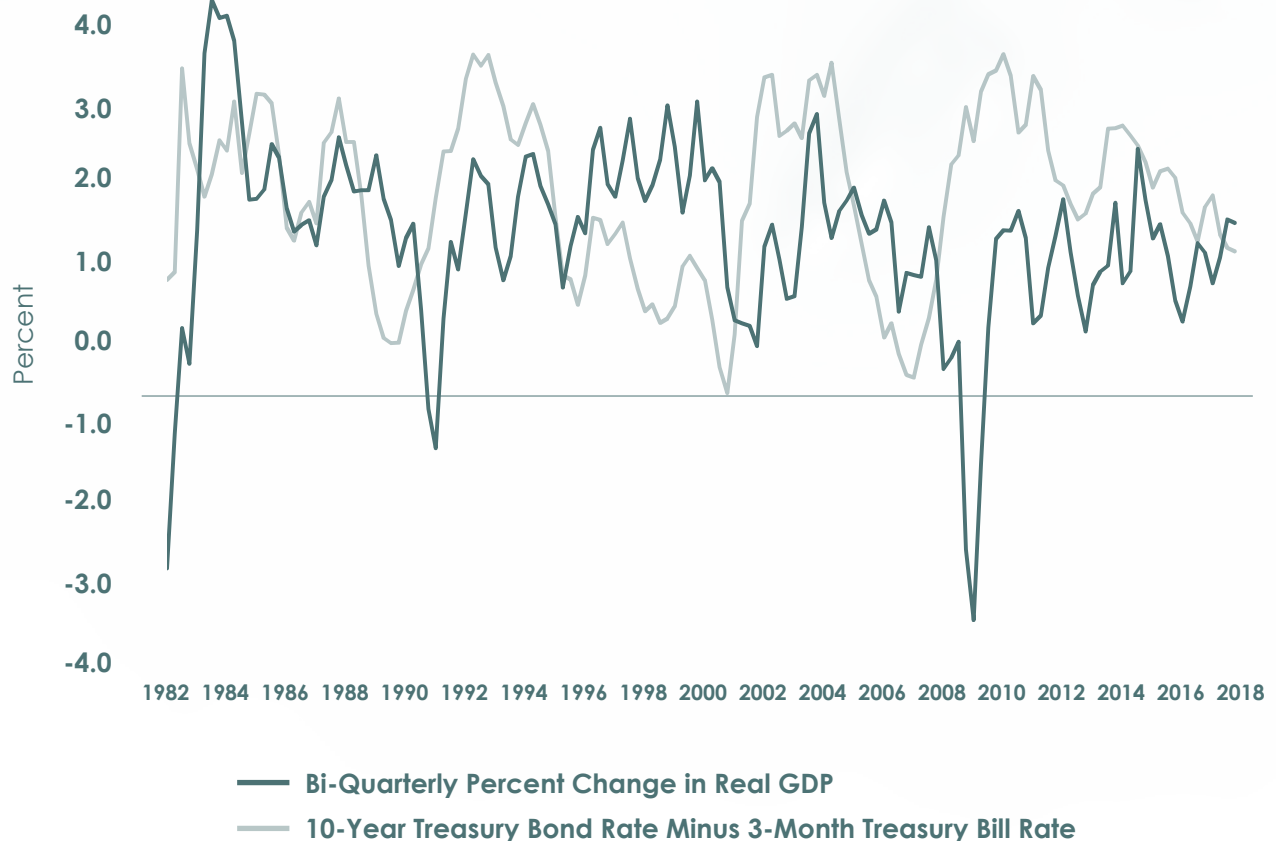
international supply chains. China's state-owned enterprises are one major source of concern. Another is the country's unregulated shadow banking system upon which a large proportion of China's small and medium-sized enterprises depend. Tighter credit conditions will make it more difficult for these organizations to support major business investments. The risk of default is also very real, which would have a far reaching dampening effect not only on the Chinese economy but on credit markets and supply chains worldwide.

- While monetary conditions have been relaxed, governments and central banks have tightened the regulation of financial institutions. Yet, there are still many unregulated intermediaries and quasi-sovereign organizations for which high levels of debt and exposure to non-performing assets pose a risk to the stability of international financial markets and
- An extended period of loose monetary conditions and low interest rates has led to record levels of household, corporate, and government debt in many major economies. Canada is no exception. Total debt levels have jumped from 287% of GDP in 2008 to more than 361% of GDP in 2017 and now exceed \$7.82 trillion.



- Canada's high debt burden makes the economy more vulnerable to any increase in interest rates. The same is true in other major economies. Higher borrowing rates will increase debt servicing charges at the expense of current spending on goods and services. They will also erode cash flow for business, which when coupled with more expensive long-term borrowing costs, will negatively impact capital investment, manufacturing output, trade, and economic growth. Capital intensive sectors like infrastructure, engineering, and construction, utilities, resource extraction and processing, manufacturing, and telecommunications are most at risk.
- The governments of the world's leading economies – with the exception of Germany – are highly indebted and continue to run sizeable fiscal deficits. In Canada, governments' increased spending on infrastructure and social programs as debt servicing costs fell in the aftermath of the financial crisis. Now, as interest rates begin to rise, governments, like Canada's, have limited room to maintain or undertake new expansionary fiscal measures without significantly increasing their borrowing requirements, and for some economies like the United States, United Kingdom, and Canada that means running larger current account and trade deficits. If anything, the expansionary tax reforms and spending measures of the Trump administration, at a time when the

The Yield Curve and Economic Growth in the United States



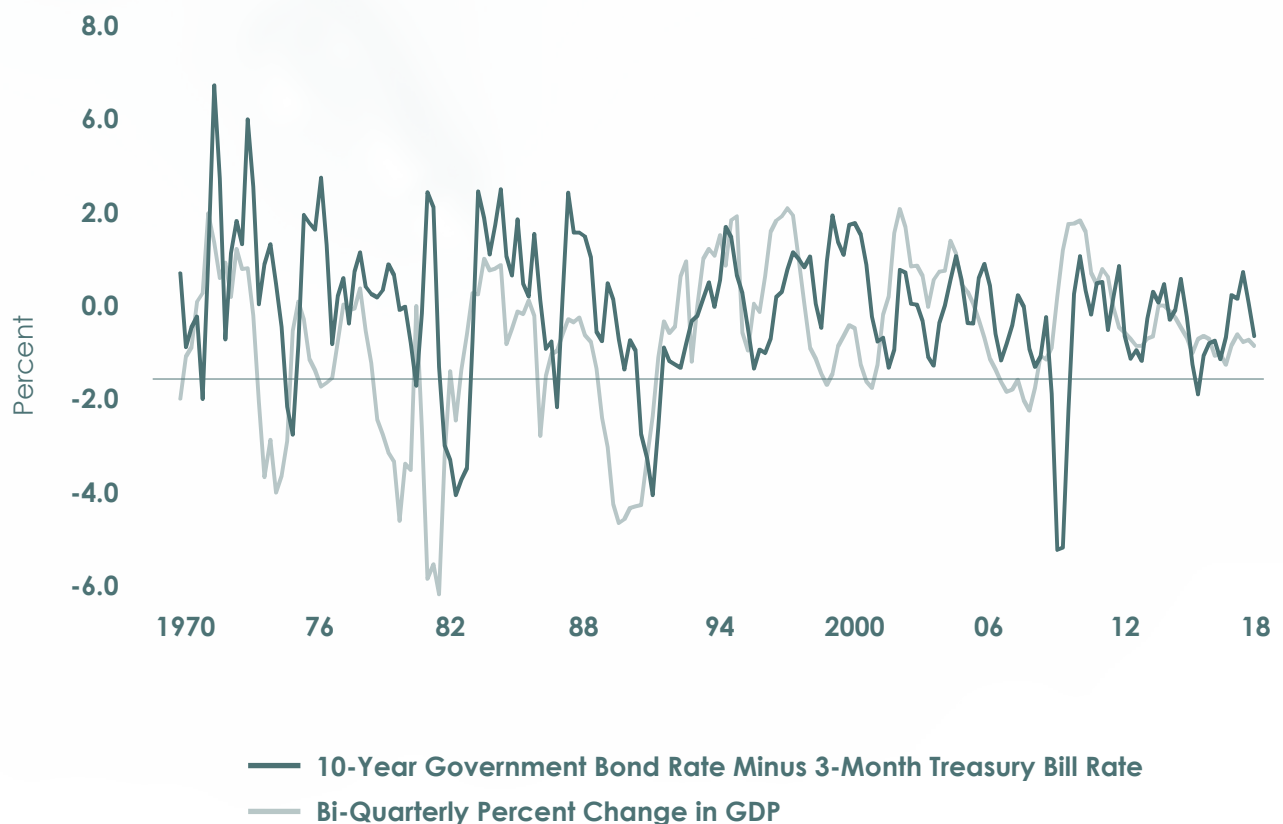


U.S. economy is operating close to full capacity, only make it more likely that the Federal Reserve will tighten credit conditions and that the U.S. trade deficit will grow even larger.

- The financial and economic imbalances that have become more pronounced since the financial crisis have also led to greater disparities in wealth and income within national economies. The crisis left high levels of unemployment in its wake, which in some economies have only now fallen to pre-recessionary levels.
- Unemployment among younger people remains relatively high. At the same time, however, earnings on the part

of individuals heavily invested in or benefiting from the inflation of asset markets have significantly outpaced national averages. The resulting imbalances in income growth have not only heightened demand for more progressive tax measures and increased government spending to address social and economic disparities, but have also become a source of popular discontent with governments, and increasingly with government institutions, that fail to respond. Monetary tightening is likely to make the situation worse if average after-tax income levels continue to lag behind increases in consumer prices and interest rates.

The Yield Curve and Economic Growth in Canada



- Central banks, including the Bank of Canada, are already increasing short-term interest rates and tightening credit conditions in the world's major economies. They are doing so because they figure that low levels of capital investment by business and the ensuing slowdown in productivity growth that has occurred since 2009 have limited the capacity of economies to expand in the face of low rates of unemployment. They are concerned that tight labour market conditions will drive up wage rates and lead to the return of high levels of inflation.

Central banks are aware of the risks that higher interest rates entail. They also know that the competitive pressures of open global markets have a dampening effect on prices. That is why, at a time of generally strong economic growth around the world, the expansionary fiscal policy and protectionist trade measures of the Trump administration are particularly worrying, especially for the U.S. Federal Reserve. But, aggressive steps by the Fed to increase

short-term interest rates at a time when international bond markets remain cautious about the tenuous nature of the international recovery may quickly put the brakes on growth in the world's largest economy. An inverted yield curve (which happens when short-term lending rates exceed long-term borrowing rates) is invariably a precursor to an economic slowdown, and frequently to recession. The same applies in Canada as well.

The Bank of Canada and other central banks will need to steer a careful course in order to cool down overheated asset markets, return household and government finances to more sustainable levels of borrowing and spending, keep inflation in check, yet avoid tipping their respective economies into recession. The risk they will be blown off course is very high. Economic and financial imbalances have made national economies and the global economy as a whole more vulnerable to shocks. At the same time, they have given rise to many of the political problems that economies face today.



## Elevated Political Risk

The political conditions necessary to manage the world's economic and financial imbalances require governments and central banks to coordinate their efforts multilaterally, keep markets open, and implement structural reforms to increase productivity, boost potential output, increase labour market participation, and make growth more inclusive. But, political trends are not looking good. The next five years will bring an elevated level of political risk for the global economy and for Canadian business, including the very real possibility of:

- The emergence of more populist governments with nationalist, isolationist, and interventionist economic policy agendas;
- Resorting to Increasing protectionism that is likely to escalate to trade wars. Resort to tariffs and other trade barriers to correct trade imbalances, like current measures touted by the Trump administration in the United States, will be highly disruptive to markets and supply chains around the world, and are only likely to lead to further retaliatory measures in their wake. Widespread trade restrictions are a sure recipe for lower rates of investment, innovation, and productivity, higher inflation, and a downturn in economic growth. With 73% of exports destined for the U.S. market, Canada is extremely vulnerable to more protectionist trade measures in the United States;
- Mounting discontent with governing institutions. Democratic institutions within states and multilateral institutions governing international trade and commerce are both at risk. The future of the World Trade Organization, the European Union, World Bank, International Monetary Fund, the institutions that regulate international finance, and the dispute settlement procedures and terms of existing trade agreements, like NAFTA – the institutions, that is, that govern the international economy – is highly uncertain as the consensus of support on the part of their members weakens;
- Continuing problems of terrorism and social violence arising in part from income disparities and barriers to inclusive economic growth;
- Increasing threats to cyber security and data privacy; and,
- An outbreak of armed conflict between states. Geo-political tensions are rising in the Korean peninsula, the Middle East, and as a result of the more aggressive foreign policies of Russia and China.

According to Export Development Canada, political risk should be top of mind for Canadian business in 2018.

# EDC's Top 10 Economic Risks to Watch in 2018

## 1. Fortress America

Our top risk remains Fortress America. Whereas last year the talk was all about the possibility of the US imposing a border adjustment tax, there is increasing concern about the future of NAFTA and what a materially renegotiated agreement or even a US withdrawal would mean for Canada.

## 2. Global protectionism

Closely connected is the worry that US actions won't stay contained but will spread internationally: the growing risk of global protectionism. The recent announcement of tariffs on aluminum and steel imports threatens to spark retaliatory actions – a key threat to world growth just as it's building momentum. Although the newly-signed Comprehensive and Progressive Agreement for Trans-Pacific Partnership counters this risk, the structure of international trade is still being challenged.

## 3. Global recession

Newcomer-global recession: Unlike the first two risks, which are being driven by a wave of anti-trade sentiment, it is unclear what the primary driver of a new recession would be; overleveraged corporations? A collapse in consumer confidence? One notable difference from the previous financial crisis is that Western governments no longer have the fiscal capacity nor their central bankers the policy room to remedy the situation.

## 4. Quasi-sovereign default

Easy lending conditions the past several years have allowed state-owned enterprises (SOEs) in emerging markets to accumulate high external debt levels. As rates rise, companies could default on debt and fail to honor amounts outstanding to suppliers. Several state-owned oil companies are particularly vulnerable given their growing debt and the somber outlook for oil prices.

## 5. Cyber attack against a major corporate or public-sector entity

Cyber theft and economic cyber sabotage used by criminal groups can inflict material damage on a country's critical infrastructure and/or corporate sector. Canada is not immune to this growing risk; the Bank of Canada has repeatedly warned that cyberattacks could undermine confidence in our financial system.

## 6. Inter-state war

Although the probability of an inter-state war remains low, it could provide a major shock to the global economy if it were not contained. As military tensions rise between Russia and the West, most notably over the skies of Syria, the potential for miscalculation and escalation grows.

## 7. China's credit/financial crisis

Financial imbalances are on the rise in China - growing debt levels, mostly involving SOEs and local government, are acknowledged and heightened risks. Total outstanding debt now stands at over 250% of GDP. A financial sector crisis due to bad debts would lead to a widespread economic slowdown and reduced demand for Canadian exports.

## 8. Conflict on the Korean Peninsula

Although the Olympics offered warm images of Korean athletes uniting, and recent diplomatic overtures by the North Korean regime have lowered the temperature and the likelihood of Conflict on the Korean Peninsula in the short-term, this risk remains ever-present and could surge again.

## 9. Automation + technology = youth unemployment

While this trend of automation and technology upsetting traditional industries is already happening, youth will be disproportionately impacted by these changes. This could have a destabilizing effect on societies, including on domestic politics.

## 10. Disorderly Brexit

This time last year Europe seemed en route to electing radical parties across the continent and putting the eurozone in its crosshairs. Instead, the centrists prevailed, and France elected its most pro-EU president in decades. While we remain concerned about a disorderly Brexit, this risk has dropped significantly from last year.

Finally, our honorable mention is a cryptocurrency-induced currency collapse. Given they are unregulated and vulnerable to theft, cryptocurrencies' rise has the potential to be very disruptive to the global money supply.

## Changing Market Conditions

Canadian businesses will have to navigate through a host of economic and political risks over the next five years. They will also have to respond to significant changes in the markets in which they operate. The rapid pace of technological change is disrupting markets, industries, and supply chains, requiring companies to compete in new ways with new business models that focus on meeting new and more demanding requirements on the part of customers, skilled employees, suppliers, investors, and stakeholders.

- Competition will become even more intense as a result of technological change. Goods and services are being rapidly commoditized. Production processes will be more readily replicated or replaced altogether by more productive, highly specialized, and increasingly intelligent automated systems. New technologies are making more goods and services obsolete. At the same time, however, they are turning products and processes into data platforms, offering businesses new opportunities to provide enhanced products and services for their customers. Business models are changing as a result of the new ways that technologies can be used to create value for customers. In the meantime, intellectual property and data are becoming the most valuable assets that businesses can deploy.
- Customers are looking for personalized experiences and highly specialized solutions in the goods and services they purchase. Environmental sustainability, social responsibility, inclusiveness, and corporate integrity are becoming more important factors in purchasing decisions, alongside considerations of cost, quality, and availability.
- Employees with the skills and experience required by businesses to compete and grow in a technology driven economy will continue to shape labour market conditions. They will be the force driving wages higher, and skills shortages will be a key determinant of productivity growth. Workplaces will also change as businesses compete to attract and retain skilled and experienced workers. Employment conditions will become more flexible, the work environment more appealing, and the workforce more diverse.
- Supply chain relationships will become more fluid as companies innovate, adopt new production and business processes, and bring new products to market. The acquisition of intellectual property, data, and technological capabilities will continue to drive industrial and supply chain restructuring. Data analytics will



lead to more tightly managed and coordinated relationships with suppliers, enable a regular recalibration of the costs and risks of logistics systems, and promote a continuous reconfiguration of supply chains. Suppliers unable to meet customer expectations will be left behind.

- Investors will continue to demand competitive and rapid returns on their investments while, at the same time, paying greater attention to factors like environmental sustainability, integrity and social responsibility, diversity, and inclusiveness that are becoming more important indicators of brand quality.
- Stakeholders and governments will also become more demanding. Companies in all sectors will need to ensure they have the social licence to operate – that they meet public expectations with respect to the health, safety, and environmental quality of their products and production processes, the integrity of their business practices, and the effectiveness of their corporate governance systems. Governments are likely to become even more stringent in terms of their regulatory activities and compliance requirements. A greater degree of consultation, communication, and transparency with social and special interest groups, governments, and the public at large will be required by business, regardless of sector, region, or size.

## New Business Opportunities

The economic, political, and market challenges facing Canadian business are daunting. But, there will also be significant opportunities for growth over the next five years.

The momentum resulting from the wide-spread global economic recovery cannot be underestimated. Business investment, trade flows, and employment growth are based first and foremost on customer demand. With demand picking up, there is likely much more resilience and capacity for productivity improvement than central banks and economic forecasters predict.

Common challenges in managing environmental sustainability and climate change, ensuring food, energy, and water security, and responding to the needs of ageing populations will create new sources of demand for innovative solutions and create additional pressures to invest in new technologies and improve productivity performance.

Government and business initiatives to increase rates of labour market participation through skills training, more inclusive hiring and employment policies, and more open immigration policies to meet business needs will have a positive impact on productivity levels and economic growth.

New technologies are creating opportunities for businesses of all sizes to connect with customers around the world, design and produce for them more highly customized solutions, and make significant productivity improvements that will help them compete and grow.

Peter Hall, Chief Economist for EDC, points to three other important areas of opportunity for Canadian business:

**1. The rise of the emerging market middle class.** More than 100 million new middle class consumers are expected to be added annually over the next five years in emerging markets. China's middle class is already growing by the equivalent of Canada's entire population every year. The base is still low. Extend this trend out a few years at the same growth rate (and China can sustain this) and Canada will be shipping as much to China as to the U.S. Canada's food sector is good a leading indicator of the kind of demand China is going to be placing on a broader range of the world's (and Canada's) goods and services

**2. India** is the next China (already). India has an army of 'surplus' labour that may be as much as 600 million strong. With the rest of the world ageing rapidly, there is a need for a large pool of labour to facilitate future growth. No other country has anything close to what India has to offer, and its population is still growing. There is lots of business for Canada to do there – like infrastructure, clean technology, smart city technologies, agri-food, energy and manufacturing.

**3. Financing** and the future of financial intermediation became hot topics in the wake of the great financial and economic turmoil of 2008-09. Higher growth is masking the problems and has dialed down the concern level, but the financial sector is still putting back the pieces of what could easily have been a near-death experience just a decade ago. In this midst of the turmoil, Canada's well-governed financial industry stood out to the world, and currently has the potential to facilitate business that other financial institutions are turning away from or are being turned away from by regulators. This presents Canada with an opportunity to provide Canadian goods and services exporters financing solutions for business opportunities that might otherwise have gone elsewhere.

## Implications for Business Strategy

It is always difficult to climb into the crow's nest in the midst of a storm, but that is exactly what Canadian businesses need to do in order to take advantage of the opportunities and guard against the risks and uncertainties that will confront them over the next five years. New strategies will be needed, at the very least to ensure businesses are not disrupted by unexpected developments in technology, customer demand, and government policy.

Successful business strategies will consider the challenges and opportunities that are likely to arise over the medium-term. They will need to:

- Focus on delivering customer value even as customer expectations continue to change;
- Be at the forefront of investor, public, and government expectations affecting their corporate brand and reputation;
- Benchmark performance against the competition and maintain competitive advantage;
- Have robust risk management and mitigation processes in place;
- Learn from the lessons of other businesses;
- Continuously improve their business processes; and,
- Invest in the people and capital required to continuously innovate and deliver the solutions that customers value most.



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