I will begin with a couple of comments that connect what Jeff Simpson said about Canadian fiscal policy and Gary’s comments on the US future. It is useful to recall that when Canada undertook its large fiscal adjustment in the mid-1990s, there had been a currency crisis in which, with a flexible exchange rate, we experienced a massive nominal depreciation to about 63 cents to the U.S dollar – compared to the two currencies being at par today. The currency crisis mobilized public support for government action which many of us had been advocating for twelve years! It is also useful to recall that this crisis occurred at a time when the US and world economies were growing. This growth helped us stabilize the debt- and deficit-to-GDP ratios quickly with rather moderate impacts on the domestic economy and on vocal interest groups.

Another general comment is that China is the elephant in this room. As I look forward, I expect that things in China will change and it could face some tougher times as the economy is rebalanced. At present, China's investment as a share of GDP is 45 percent, which is off the charts. This large investment share represents huge increases in industrial capacity and infrastructure – at times creating excess capacity. These capital investments are in part driven by China’s subsidized input prices. Energy prices are subsidized. Land is subsidized. Borrowing from the government-owned banks is artificially cheap. And the state-owned enterprises at the commanding heights of the economy don’t pay much to the state in dividends. So the whole machine right now is geared to investment and exports, rather than consumption and imports.

Monetary policy is geared towards stabilizing the exchange rate; interest rates are decreed, paying savers very low rates but allowing banks generous spreads, with higher rates charged to borrowers. And so you've got this riskless spread that the banking system still relies upon. For consumption to become a larger share of GDP -- it's in the mid-30s right now, compared to India at 55 percent and U.S. at 70 percent – higher input prices for producers, higher wages, more competition and deregulation and changes in the financial system to provide greater access by job-creating SMES are all necessary.

The Chinese authorities are in the process of approving the 12th Five Year Plan (2011-15). One of the major goals in the Plan is to shift economic activity more towards household consumption and away from investment and industry. This means we can expect competitive pressures within China that are going to have an impact over the next five to ten years.

For Canada, the change in Chinese priorities implies at least three future challenges. First, and relevant to the morning’s discussions, is North American integration. Looking at Asia -- where a lot of work is underway to deepen economic integration and where good-producing regional production networks are tying the region together around the Chinese and other assembly bases – I am struck by the stark contrast in North America where, if anything, we are pedaling backwards. We are dis-integrating as borders thicken.

As we all know, Canada and the U.S. are deeply interdependent. Canada exports a third of our GDP, with 75 percent of our goods and half of our services exports going to the United States. In my second slide
we see, even so, that two-way Canada-US trade is still larger than China-US trade. We're the largest foreign energy supplier. Twenty percent of imported crude comes from Canada, 90 percent of imported natural gas, and the electricity grid in the Northeast is fed from Canada. In the third slide, second panel, you can see the surge in FDI flows from Canada into financial services in the U.S. as a number of Canadian financial institutions make US acquisitions.

But there is a new obstacle: the thickening border driven by US security concerns. The thickening border is like a tariff in that it raises transaction costs. A few studies have tried to calculate the costs and one shows that if you leave out softwood lumber, which is a special managed trade sector between the two countries, and oil and gas which has its own infrastructure, the remainder of goods trade has suffered since in 2007 when this study was done. It found that trade in goods between Canada and the U.S. was $31 billion or 12.5 percent lower than the trade model predicted. Service exports were eight percent below what they should be and service imports were 18 percent below. One of the implications, beyond joint task forces to address these issues, is that Canada should reduce its dependence on the U.S. market and diversify its options.

The second and related challenge for Canada is what I call the gravity shift. With the shift of economic gravity to Asia, the demand from the Asian exporters for natural resources is, of course, having a positive economic impact on Canada. China is now the world's largest importer of iron ore, copper, a number of other commodities, of timber products and potash. The underlying challenge for Canada is to avoid Dutch Disease, where we could do so well exporting natural resources that the exchange rate appreciates and upward pressures on wages and input costs could put the non-resource sectors of the economy at a disadvantage.

In slide 4 you can see the diversification of our trade with the rest of the world through growth in exports and imports. China is now our second largest country trading partner and trade is growing fast. In contrast, Canada-US trade, which is still the largest in terms of share, is slowing down. In the fifth slide you can see the diversification of markets for softwood lumber, the sector that has experienced a long-running bilateral trade dispute. While Canada-US trade is now managed in this sector, Chinese demand for timber is going up.

The third issue is demographic. In slide 6 it is evident that Canada is aging faster than the United States and Mexico; this trend will impact on our fiscal situation as health care costs make ever-growing demands on the public purse at the expense of other priorities such as education, as is evident in slide 7.

How should Canada respond? The fundamental issue is our productivity performance, which is clear in the last slide where labor productivity has been lagging the competition. Each of our challenges will be dealt with in part by improving our productivity performance. We are doing well on public investment in research, but not so well on business investment in R&D. There are other issues as well, such as the border barriers within the North American economic space. There are also a number of things we can do at home in terms of strengthening the connections between our research facilities and their commercialization between our universities and business, and a lot we can do in education as well.

The other thing that I think we have fix are market access problems. I'm not going to say much about NAFTA. I think it's a great platform to build on, but it's dated and it has to be modernized. We have to work on the border, but how do we update NAFTA? Most of the discussion in Canada is about incremental changes. A game changer, however, would be to join the Trans-Pacific Partnership, which is the only trade game in Washington that has momentum and is seen as a strategic initiative to signal to China that Asia is not its backyard.

Fiscal restructuring and trade diversification are the other two issues. We need to taper down stimulus spending as soon as possible in order to make room for the spending that will come with the aging
population. And policy should encourage trade diversification, which is being driven mainly by market forces. We're negotiating with the Europeans and starting talks with India. I think that we should get much more serious about the TPP.

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