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Canada's Economy, a strategic solution

By Mark Sibthorpe

This report explores Canada's strategies to compete globally. The report begins with an analyses of the housing market, because housing is the canary in the coal mine; explores what happens in the event of collapse; and analyses the underlying problem causing Canada to be uncompetitive.

The report is organized as follows:

Part 1: Examines 2008 US housing crash & Canada's looming housing bubble.

Part 2: Summarizes the Occupy (Rousseau) movement and outlines political risk.

Part 3: Examines Canada's economic strategies such as tax incentives.

Greenspan 'Never saw it coming' will Canada?
Image by Madeleine Sibthorpe

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Contents

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Part 1: Canary in the coal mine

The source of risk to Canada's housing industry and Canada's weak competitive position are caused by the same problem. This is why understanding Canada's housing industry risk, lends itself to understanding the problems facing Canada's economy in its entirety.

October 20, 2014 the mood among Canada's political and regulatory leaders is jittery, especially within Canada's financial service and resource industries. The cause is the likelihood that we are at the bursting point of a housing bubble, stocks are tanking, and oil prices are nearing $80 a barrel. Ironically, in the build-up to the current situation, Canada's leaders have played down the threats. For example, Joe Oliver, Canada's Minister of Finance, recently disputed talk of a housing bubble, and reversed course with respect to previous measures intended to cool the housing market and protect taxpayers against risk.

Housing policy reversals

Policy reversals were also announced by Jeremy Rudin, the Superintendent of OSFI. The strategy is to relax regulations and maintain ultra-low interest rates. This poses a risk for taxpayers because of the structure of the Canada Mortgage and Housing Corporation (CMHC) which puts the liability of a downturn on tax payers. These policy reversal have alarmed the IMF and Pimco's Ed Delvin. This is because they recognize the indicators (see page 2) and, therefore, advocate the need for intervention by the Bank of Canada (BoC), in order to halt the housing "bubble."

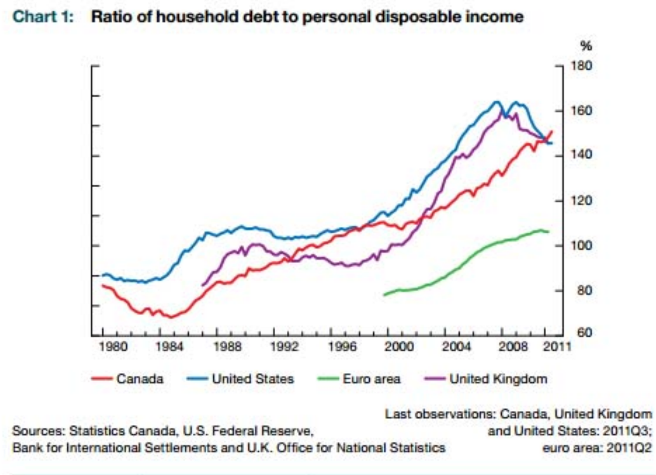
For the backstory on this, I have included an extract from a spicy 2012 blog post by Steve Garganis, a mortgage industry commentator. In the blog that follows, Garganis' main concern was that Julie Dickson, former Superintendent at OSFI, had taken what Garganis felt was a detrimental stance on housing that would restrict industry growth. A logical conclusion and exactly what Dickson, and the late Minister of Finance, Jim Flaherty, had intended. As mentioned, the duo voiced public concern about the potential risk to taxpayers in the event of a housing downturn. Here is the blog extract:[1]

1. *Did you know that our Federal govt approved and promoted $0 money down mortgages, with interest only payments?? and not just for owner occupied properties but for rental properties, too? Think about that… $0 money down with interest only payments on a rental property!!!*
2. *How about the 35 and 40 year mortgage amortizations? 95% loan to value refinances? We also had 107% mortgage financing in Canada… (not supported by govt of Cda but it was here)…*
3. ***Remember (when) all these programs started to get introduced? In 2006,** just 2 years before the October 2008 U.S. sub-prime mortgage crisis.*
4. *And to make matters worse, our federal govt decided to put CMHC (Canada Mortgage and Housing Corporation) under the control of OSFI. Let's remember that CMHC is a national housing agency that was created to make owning a home more affordable. But now it's under the control of an auditor?*

Garganis' further adds that he thinks Dickson's subsequent resignation was a cop-out. As he puts it: *she decided not to stick around after making more lending rule changes in 2012, than I have ever seen during my entire 23 year career.*

[1] To read the original post click the following link

Current housing risks



Despite rhetoric to cool the market, it is clear from the indicators that follow, that Dickson's and Flaherty's policies did not have the desired cooling effect on house prices. This is shown by the following indicators:

1. Housing prices are up 4.9% since 2013, and 20% overvalued according to Fitch;
2. Housing affordability which is reportedly at an all-time low, especially for first time buyers. The Economist puts housing affordability as a percentage of income among the highest in the world. Up there with Hong Kong and New Zealand. (DH, 2014);
3. Debt to income ratio of 163.6 per cent (see Chart 1 below),
4. Poor job data with the jobless rate at 7%;
5. A manufacturing shift that leaves 1.7 million employed in the manufacturing sector this year compared to 2.3 million a decade ago;
6. The failure for [non-energy] exports to recover;
7. GDP growth rate of 2.1%, up from –2.8% in 2009;
8. Drop in oil prices = reduced tax revenue and lower resource investment.

Why, with a high debt to income ratio, low home affordability and ongoing stagnant growth, has the current Minister of Finance and OSFI Superintendent reversed course?

The reason, according to Oliver is that he does not see a bubble. Which is why his approach seems to follow that of the 'eponymous protagonist,'[2] Alan Greenspan, the former Chairman of the Federal Reserve Bank. In Greenspan's own words, he "never saw it coming." (Greenspan, 2013)

Greenspan 'Never saw it coming' in place of Don Quixote drawn by Madeleine Sibthorpe

Background on Greenspan:

1. **Legacy of failure.** Bloomberg's Barry Ritholtz succinctly summarized the issues that led to the credit crisis.

[2] A term used describe Cervantes well known hero Don Quixote. Don Quixote by Miguel de Cervantes, first published in 1605, was written during the latter part of a historical period known as the Spanish Golden Age, during the Eighty Years' War, or Dutch War of Independence (1568–1648), a revolt by the Habsburg Netherlands to end Spanish rule. *Don Quixote, the eponymous protagonist, who consistently misinterprets his own, his adversaries', and his allies' actions and motives — regularly resulting in apparently unjustified violent actions and consequences.*

2. **Fraud.** Ravi Batra in his 2005 book, "Greenspan's Fraud," details how Greenspan used the threat of real pension shortfalls to justify dramatic social security tax hikes. Instead of placing these funds into secure instruments, these trillions of pensioner's retirement savings have been used to fund deficit spending.
3. From Yves Smith:
    a. Sees Greenspan as the key to "control fraud" — cases where the officers who control what look like legitimate entities use them as "weapons" to commit crimes. Each time, Alan Greenspan, former chairman of the Federal Reserve, played a catastrophic role. First, his policies created the fraud-friendly (criminogenic) environment that produces epidemics of control fraud, then he failed to identify those epidemics and incipient crises, and finally, he failed to counter them.
    b. Claims that Alan Greenspan, chairman of an economic consulting firm at the time, urged us to permit Lincoln Savings to go full steam ahead. His memo supporting Lincoln's application to make hundreds of millions of dollars in direct investments praised the company's management (Keating) and claimed that Lincoln Savings "posed no foreseeable risk of loss."
    c. Argues there was no excuse for assuming fraud out of existence, and his exceptionally immoral position on fraud and regulation proved catastrophic to America and much of the world. We cannot afford the price, measured in many trillions of dollars, over 10 million jobs, and endless suffering, of unethical economists.

Based on comments from Ritholtz, Smith, and Batra, explanations for his actions indicate that Greenspan may have been a puppet for big business, or simply corrupt. Another explanation is that he was simply confounded by reality.

Greenspan on China

To support the latter argument is a recent Greenspan report in Foreign Affairs. His premise being that China will dump its US treasuries and buy gold. The following is an extract:

1. *If China were to convert a relatively modest part of its $4 trillion foreign exchange reserves into gold, the country's currency could take on unexpected strength in today's international financial system. It would be a gamble, of course, for China to use part of its reserves to buy enough gold bullion to displace the United States from its position as the world's largest holder of monetary gold. (As of spring 2014, U.S. holdings amounted to $328 billion.) But the penalty for being wrong, in terms of lost interest and the cost of storage, would be modest. For the rest of the world, gold prices would certainly rise, but only during the period of accumulation. They would likely fall back once China reached its goal.*
2. *However much gold China accumulates, though, a larger issue remains unresolved: whether free, unregulated capital markets can coexist with an authoritarian state. China has progressed a long way from the early initiatives of Chinese leader Deng Xiaoping. It is approaching the unthinkable goal of matching the United States in total GDP, even if only in terms of purchasing-power parity. But going forward, the large gains of recent years are going to become ever more difficult to sustain.*

3. *… A culture that is politically highly conformist leaves little room for unorthodox thinking. By definition, innovation requires stepping outside the bounds of conventional wisdom, which is always difficult in a society that inhibits freedom of speech and action.*

Sensational assertions that, if acted upon, would at minimum undermine the US dollar and strengthen China's currency; assertions that do not stand up in the cold light of day. Here are the indicators that support this latter view:

1. Purely as a measure of GDP growth, China, by a huge margin, has been the long-term winner in a USD dominated world. Taking its US reserves and buying gold would harm the US and might be considered an act of economic warfare and would surely shut them out the U.S. a market.

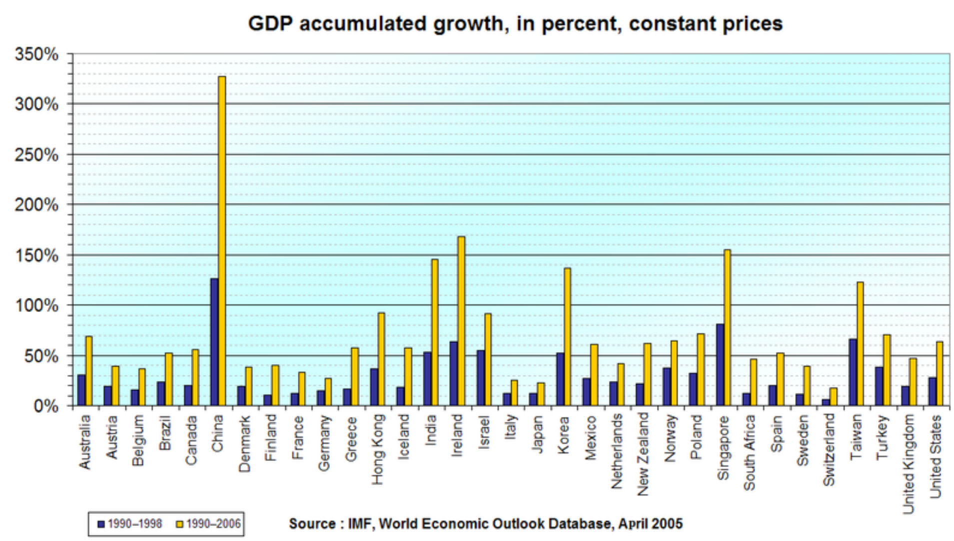


Chart 2, GDP Growth

2. According the Financial Times: by some measures, i.e. Purchasing Power Parity (PPP), China's economy is already bigger than the US; US economy $17.4tr vs China $17.6tr (see footnote).[3]
3. Emerging markets' output relative to the advanced world accounted for more than 50 per cent of global output in 2007 and are roaring ahead, now accounting for 57 per cent. [4]
4. Emerging economy growth compared to the advanced world between 2007 and 2014 was nine times as fast. [5]
5. The US, has a history of changing the currency rules to the detriment of other nations whenever they get in trouble. I.e. the 1971 dollar crisis.

Judging by the situation presented above, China has much to be grateful for as a result of economic ties to the US and free trade in general. Therefore to counter Greenspan, apart from being politically inept,

[3] Be sure to read blog: http://blog.mpettis.com/2014/05/do-we-understand-the-math-behind-the-ppp-calculations/ for understanding of PPP.
[4] Be sure to read blog: http://blog.mpettis.com/2014/05/do-we-understand-the-math-behind-the-ppp-calculations/ for understanding of PPP.
[5] Be sure to read blog: http://blog.mpettis.com/2014/05/do-we-understand-the-math-behind-the-ppp-calculations/ for understanding of PPP.

actions by China to strengthen its currency would go against its economic policy designed to keep its currency weak: weak yuan = cheap exports.

As to Greenspan's jabs about the Chinese not being able to think outside the box and lacking innovation: 300% GDP growth since the 90s, and, by some measures, a bigger economy than the US = Is he serious?

In summary, Greenspan's unregulated market cost tens of millions of jobs, all because he was incapable of recognizing the threat this posed to the economy. This should give pause to Canada's leaders because the indicators in Canada are about the same or worse than in the US before the crash.

Part 2: Social Unrest: Occupy Yellen – Occupy Rousseau

Occupy Yellen – Occupy Rousseau

Janet Yellen, Chairman of the Federal Reserve Bank, said, "It is no secret that the past few decades of widening inequality can be summed up as significant income and wealth gains for those at the very top and stagnant living standards for the majority." (Spicer, 2014) When the Chairman of the Federal Reserve signs up for Occupy, it is a sign that change is due and housing could precipitate massive political change.

As expected, the consequence of a Canadian housing crash (i.e. when the canary dies) will not be felt around the globe; but for Canadian politicians, there will be electoral consequences. Examples of this are already evident. Look at the political cost for the Quebec Liberals as shown in their 2012 election loss attributed to student protests. More recently, thousands of protesters gathered in Montreal to protest austerity measures contained in the provincial budget. (CBC, 2014)

People are suffering, and Yellen feels the income disparity does not reflect US values. (Spicer, 2014) This has prompted a movement referred to by some as "Occupy Rousseau." (Barber, 2012) Aptly named because of the tradition started with Jean-Jacques Rousseau, who popularized the concept the "Social Contract." The concept being the result of his determination to understand how freedom may be possible in society. The historical importance of this being the fact that his revolutionary ideas helped fuel the American and French revolutions, and were co-opted into the US constitution. Yellen's statements are a reflection of this tradition which can be felt in global protests, such as Hong Kong, Scotland, Portugal, Greece, Italy and Occupy Wall Street in the US.

Rousseau's philosophy may even offer insight into the impact the global economic crisis is having on less Free states such as Russia and Iran; though oil might be a better explanation. For example, Russia's opposition leader Alexey Navalny, has found a voice, the voice of a man that has vowed to destroy the "feudal system of power" lorded over by Vladimir Putin. Here is how he describes the problem facing Russia today:

> *It's been 15 years since huge oil and gas money arrived and what has it brought to the country? Did we get better access to medicine, education, and housing conditions? What did we get – those of us on this or that side of the defendants' bench? The only thing that became more accessible to our people now than in Soviet times is vodka.*[6]

[6] http://www.theguardian.com/world/2013/jul/05/russian-opposition-destroy-feudal-system-alexey-navalny

Thomas L. Friedman, author of Hot, Flat, and Crowded would agree with Navalny. (Friedman, 2005) Chart 13 from Friedman's illustrates the correlation between crude prices and freedom:

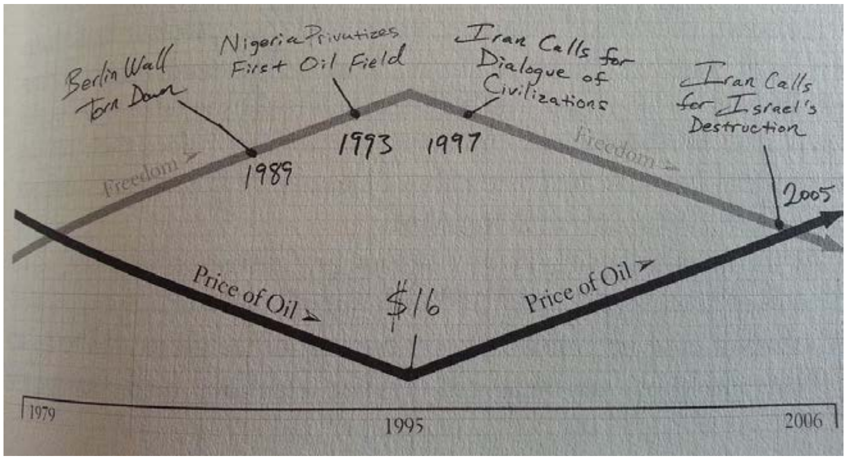


Chart 3: Freedom vs. Crude Oil Prices

In this context, Navalny's plight is representative of Freedman's analysis between oil and freedom; literally, oil is the fuel powering Putin's rule.

Incidentally, oil prices have recently tumbled. Along with this, stocks and the Canadian dollar. This will put additional pressure on the Canadian economy for a variety of reasons, exacerbating the housing risk. It will also increase the likelihood Putin (Poutine in Quebec) will soften his stance on Ukraine. These issues will be addressed in part 3.

Part 3 Strategy: Art of War

So far we have demonstrated the fact that leaders did not anticipate the risks accurately in the lead up to the credit crisis. From this vantage point, I will look at some of the main economic problems facing Canada, and evaluate the strategies used to deal with them.

Table 1 outlines three problems causing economic drag.

IIssue	Mitigating action	Financial impact	Social impact	Recommended strategy change	Threat level
Uncompetitive manufacturing industry	Higher taxes for middle class/Deficit Spending/Increase Reserves	Lost jobs erodes tax base	600,000 lost jobs	• Devalue currency • Direct investment in machinery • Direct funding for strategic shared R&D available to all companies equally	Mediu m

Resource based (oil) economy and debt financed nation funded by growing reserve currency	Increase reserves and no currency intervention/barring Russia from SWIFT, economic sanctions on Russia/QE/ High currency reserves	Dutch disease/ Increased Political risk Middle East Reduced manufacturing base and trade deficits • Keeps dollar Value high • crowds out manufacturing Trade deficits	• Creates high paying jobs • Environment al risk • Fuels consumer society	• Use tax revenue to fund renewable resources research, technologies …	High
Aging population	• Increase age of retirement • Reduced state security and income supplement	Surplus liquidity due to retirement savings / lower GDP / increased health spending	• Reduced returns in investments • Ratio of workers to retired impacted • Increased health and pension costs Overall lower productivity • By 2021 19% over 65		Mediu m

Table 1, known economic challenges:

According the Foreign Affairs, Trade and Development Canada, 2010 report, “Canada lost nearly one-quarter of our (US) market share in 9 years.” This implies Canada is not competitive and accounts for the resulting job losses. For example, take the automotive industry, Andrew Coyne, a writer for the National Post says we should not even try to compete. As he says in reference to the billions in subsidies given to the auto industry: …*is (there) any economic rationale for taking from every other company and industry, the ones that can compete without subsidy, to give to a company that, by its own account, can’t*. (Coyne, 2014) Deciding how to allocate resource, therefore, needs to be part of a larger strategy.

Canada’s trade strategy

It is important to have a competitive economy, job creation depends on it, and by extension, people’s ability to pay mortgages. Unfortunately, based on government reports, we are not competing effectively. This is not a new problem, a good example of this issue goes back to the 1998 Canada’s jobs strategy. At the time, unemployment was at 11% and Canada’s goal, set in 1995, was “to double the number of Canadian exporters by the year 2000.” The results shown on table 2:

Value of exports	1995-2000	2000-2008	2008-2009
Total Effect	141.480	18.489	-103.569
Competitiveness Effect	-9,173	-64,804	-11.744
Product Effect	-3.398	3.483	-17.137
Growth Effect	154.051	79.810	-74.689

Table 2, Value of exports Source: Foreign Affairs, Trade and Development Canada

According to Foreign Affairs Canada: while in the 1995-2000 period Canada mostly kept its slice of a rapidly growing pie, in 2000-2009 Canada received a shrinking slice of a same-size pie (the pie being the U.S. import market). The product mix effect has been significant in particular sectors, but made a significant overall contribution only in 2009, mostly due to weakening prices for energy and some other resources. However, almost all of the market share decline that took place before 2009 can be traced to weakening competitiveness. (Foreign Affairs, 2010)

As demonstrated by Chart 2, China has had the opposite problem, i.e. managing 300% GDP growth. Here is a look at what one analyst attributes to China's competitive market:

China Guanxi

As opposed to Canada, with a declining market share, China has continued to grow. To the point where it's GDP, by some measures, is stronger than the US's. Therefore, before analysing Canada's weakness, I will look at what makes China's model for growth work. According to Edward Tse, in a 2005 article that appeared in www.strategy-business.com, China has 5 key growth drivers:

1. Belief that China will be the world's largest economy.
2. Investment and risk taking
    a. 3rd largest R&D
    b. Fearless experimentation
    c. China has doubled the number of engineers it graduated between 1996 and 2001. These individuals are a source of cheap labor and a supportive climate for invention and
    d. Financial support making China the third-largest R&D investment
    e. Willingness to take chances and learn from failure, especially compared to their more risk-averse Western counterparts. They require a relatively low burden of proof when deciding to invest in a new product or technology.
    f. Leadership training sessions, held either in China or at top academic institutions overseas
3. China's "Brain Gain"
    a. Lured by economic reforms, by the excitement of building a nation, and by the central government's incentives, foreign-trained and expatriate managers are bringing credibility, leadership, and financial and marketing skills to the executive suites of Chinese companies.
4. Connections "Guanxi"
    a. Strong Diaspora: 73 percent of Chinese immigrant professionals said they would consider establishing businesses back in their homeland — and a large number had already done so.
    b. World's biggest management laboratory
    c. Combining Japanese, Korean, European, Australian, and American multinationals compete against overseas Chinese and local Chinese state-owned and privately owned players.
    d. Use their acquisitions to gain management expertise and good governance structures from abroad

   e. Together, government liberalization (in some industry sectors) and global integration have changed the rules of the game. Conventional wisdom makes much of the mystique of *guanxi* — a word that strictly translates as "connections,"
5. China's Overseas Ambition
   a. Secure the supply of resources such as oil and raw materials
   b. Enter new markets (often by acquiring local brands and distribution networks)
   c. Gain new skills and technological competence
   d. Gambling that investing in the developing world will pay off enormously. In Africa, for example, China's economic, commercial, and political relationships with Zimbabwe, Angola, Sudan, South Africa, and Nigeria have grown rapidly in the last few years.

Note also that China has 275 known state owned assets (SOA) as of March 2014, with 35% of business activity and 43% of profits in the People's Republic of China controlled by SOA. This implies that these assets can be made to adhere to government policies along with state controlled bank funding..

As shown above, there are many factors to explain why China has been in a growth mode. Incidentally, Canada too has grown in some sectors while losing ground in others. Here are some highlights:

- Pharmaceutical exports increased 136% between 2001 and 2012;
- Growth in the information and communications technologies (ICT) sector. Revenues in the ICT sector increased by 5.6% in 2011, led by the software and computer services industries which posted the fasted growth (7.3%). (Industry-Canada, 2013). ICT industries are the largest performers of private sector R&D;
- Lost 600,000 manufacturing jobs.

R&D Strategy Review

To give a sense as to the importance of R&D, one only needs to refer to the computer algorithm that led to the Google search engine and a multi-billion-dollar business was developed by Larry Page and Sergey Brin while they were working as graduate students under part of a $4.5 million National Science Foundation grant for a digital library project at Stanford University. (AAAS, 2012)

Once again, with respect to R&D investments, Canada is not a laggard. In fact, as table 3 indicates, compared to China, Canada's 2006 R&D subsidies as a percentage of GDP is much higher. Of course this is not in terms of gross spend, China is has the 3rd highest R&D spend in the world.

Table. Total R&D as Percent of Gross Domestic Product (GDP), 2006 (selected nations)

Nation	Total R&D / GDP Ratio	Gov't R&D / GDP Ratio	Industry R&D / GDP Ratio
Sweden	3.73%		
Finland	3.45%		
Japan	3.39%	0.55%	2.62%
South Korea	3.23%	0.74%	2.43%
United States	**2.62%**	**0.77%**	**1.70%**
Taiwan	2.58%		
Germany	2.53%		
Singapore	2.31%		
France	2.11%		
Canada	1.94%	0.63%	0.93%
United Kingdom	1.78%	0.57%	0.81%
European Union	**1.76%**		
China	1.42%		
Ireland	1.32%	0.40%	0.78%
Spain	1.20%	0.51%	0.57%
Italy 1/	1.09%		
Russia	1.08%		

SOURCE: OECD, Main Science and Technology Indicators, 2008.
1 - 2005 data.

EU data are for 27 EU nations.

Table 3, global R&D investment

ICT Example

The main way R&D investment is deployed in Canada's information and Communication Technologies (ICT) industry is mainly through tax credits. In ICT this has resulted in impressive gains. This is an export-oriented segment, with about 58% of ICT products exported in 2011. Within the ICT industry there are some standouts that have even better economic indicators. For example, as a subset of ICT, Canada employed 16,500 people in the video game industry in 2012. Quebec's video game industry is the largest by employment with approximately 8750 full time (jobs) employment (FTEs) in 2012. British Columbia hosts Canada's second largest provincial video game industry with 5150 FTEs (direct jobs). Ontario's video game industry is third largest with roughly 1,850 direct FTEs, although it leads in terms of number of studios). This high job rate in Quebec and BC is because a clear majority of this industry's employment is created by larger employers (500+ people). In contrast, 73% of video game employment in Ontario is created by medium-sized firms (with 100 to 499 people).In total, the video game industry generated over $2.3 billion in Gross Domestic Product (GDP) for the Canadian economy in 2012. Of that, the direct-impact GDP in the video game industry was nearly $1.4 billion in 2012. The industry also generated $428.9 million in indirect-impact GDP and $495.0 million in induced-impact GDP. (Canada C. B., 2012)

To the credit of government policies, as shown by industry survey results shown on table 4, the Canadian government strategy of sector support is considered satisfactory by the growing video game industry. An outline of the available tax incentives can be seen on table 5.

Businessactivity Average score	Average score
Research & Development	2.87
Human resources (including labour costs)	2.36
Training	2.02
Marketing	1.83
Business information	1.83
Financing and Access to Capital	1.77
Recruiting (including international/immigration)	1.57

Table 4 – Satisfaction with government support by area of business. 1 not at all to 5, extremely satisfied.

Jurisdiction	Title of Intervention	Key Features
BC	Tax Credit	17.5%
Quebec	Tax Credit	26.25%
Ontario	Tax Credit	40% labour expenditures and up to $100,000 of eligible marketing and distribution expenditures. & 35% for qualified expenses.

Table 5, Video Gaming tax credits. Source KPMG 2012

On top of industry specific tax credits, Canada has remained the most competitive business tax environment worldwide. (KPMG, 2014) Some example, of Canada's tax advantage versus the US:

- Digital technologies is 82.9%;
- R&D it is 69.4%;
- Manufacturing 34.5%.

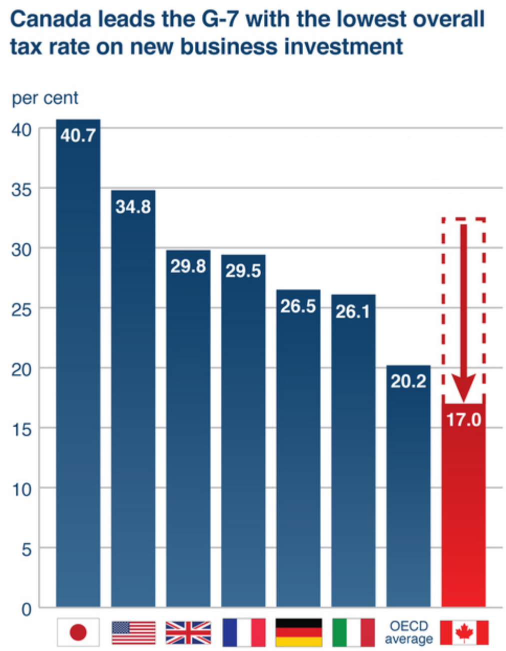


Chart 5, tax rate by country (Commissioner, 2014)

Based on government support as shown on table 2, 3 and chart 5, video game makers have a financial advantage over other countries. Nordicity indicates the following results:

- 60% of companies are planning to expand their business activities to the US in the next 12-24 months;
- 47% plan to expand to the UK;
- Many companies also believe that cloud gaming and free-to-play gaming models represent key opportunities for industry growth. (Nordicity, 2013)

China, in comparison, offers far less to video game developers. According to a China-Briefing 2013 report, China offers a reduced CIT rate of 15 percent. For video games, China is subject to significant censorship and regulatory controls that limit industry growth. Although censorship would be a great strategy in an industry where they are weak.

Testimonials from Canada's CEOs

According to Canada's CEO's, Canada has other strategic benefits, not just tax credits. Click the links in the following to view video testimonials:

General Mills

Talent Pool: highly developed work force. Among G7 highest % of adults completed post-secondary population. UofT and McGill rank among the best in the world.

Quintiles Pharma innovation

R&D tax incentives

Hub of innovation

Commercializes strongly

One of the best places in the world to live

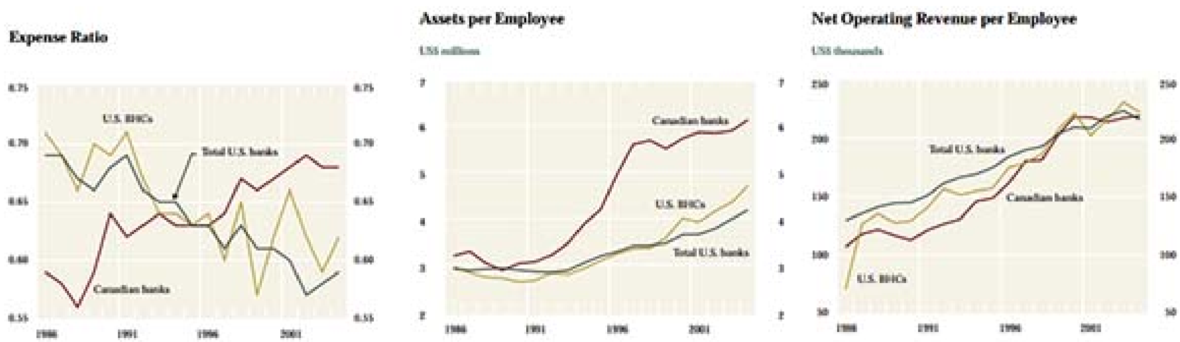
AMD

Stable work force

Lowest turnover in the world 7% vs 20% in China

Comparative advantage

Apart from subjective testimonials, data also supports comparative advantages in key industries. For example, the financial service sector has several measurable advantages including a sympathetic tax regime, lower rents, and a competitively priced, highly skilled and efficient workforce. A study that backs this up was conducted by the Bank of Canada in 2007. In the study, it was shown that Canadian employees handle more assets, have a comparable operating revenue per employee, and a superior expense ratio. See the charts below from the 2007 Bank of Canada Review, "Efficiency and Competition in Canadian Banking."



Charts 6, 7, 8, demonstrate efficiency in Canada's financial service industry. Source Bank of Canada

Comparing salaries in Montreal's financial service industry and comparable rents puts Montreal ahead by a considerable margin. Montreal vs New York and Boston show the following savings:

- Rent is more than 50% less expensive;
- Salaries are 20% less costly;
- 24% tax credit available.

Canada's FIs also receive significant benefit from:

- A strong regulatory environment;
- Shared services and infrastructure such as Interac, CPA, CMHC, CDIC, Celero shared IT costs for credit unions.

The shared services available to Canadian banks reduce risks and costs and create significant efficiencies. As an example, the CMHC assumes risk for mortgage defaults, the CDIC insure retail deposits and Interac efficiently process all debit card transactions.

Tax issues

Analysis of tax incentives, including lower corporate taxes contributed to Burger King, in its decision to take over Tim Hortons. To give a sense of the value of these tax avoidance schemes, consider that because inversion deals may no longer be permitted as a consequence of the publicity surrounding the Burger King controversy, billions were wiped from share values recently. A fact which, according to the Financial Post's, Nicolas Van Praet, was equivalent to about $12.3 billion in value for nearly a dozen companies in North America and Europe. Even with tax savings, not everyone agrees that the benefits of inversions are enough to justify the business case. Here is what the LA Times had to say about inversions:

> *For several reasons, S&P said firms considering an offshore tax shift should be guided by the Latin phrase caveat emptor, or let the buyer beware.*
>
> *"An effective inversion strategy should make sense for business fundamentals and not just for tax reasons," the report said.*
>
> *Firms take on higher debt to pay for the foreign acquisition, which also reduces their ability to make other strategic purchases to improve their business, S&P said.*
>
> *Inversions also give companies easier access to foreign earnings, which can lead to "more aggressive share buybacks and dividend payments" that also can damage credit ratings.*

Despite the arguments against inversions, the Burger King example draws attention to Canada's tax policies that had been enticing to some companies to set up shop in Canada. However, as the LA Times argues, inversions are not always the best for the companies or the target country.

A recent US Senate subcommittee that looked at inversions offers clues as to why they do not lead to increased investment or jobs for the target country. Centred on Apple's offshore tax practices, the discussions revealed that the amount of corporate money (not just Apple) held in offshore accounts could exceed $1 trillion. The relevance for Canada being the way these funds are held. According to the CheatSheet, **Apple Invest Its Cash Pile in the following way**:

- $54.1 billion in corporate securities, representing the biggest capital allocation category.
- U.S. Treasury securities accounted for $31.3 billion, an increase of 55 percent from the end of September;
- U.S. agency securities accounted for $18.1 billion;
- Mortgage and asset-backed securities represented $15.1 billion of Apple's portfolio;
- Other smaller categories like non-U.S. government securities, certificates of deposit and time deposits, commercial paper, and municipal securities accounted for $4.8 billion, $2.1 billion, $3 billion, and $6.3 billion, respectively.

The data shows that the countries providing billions in tax breaks to Apple get zero benefit from its cash hoards in return.

According to the Financial Times, Vanessa Houlder, "Revelations about Google's tax planning have stoked widespread public anger, prompting politicians to launch an international crackdown on corporate profit shifting." The problems raised by digital companies is one of the central issues being addressed by the initiative launched by the G20 group of leading economies this summer. (Houlder,

2013) The interesting bit is tjhat Google, a company whose original research was funded by a US research grant, only pays 5% on corporate earnings because it routs profit made in Ireland its Ireland shell (tax 12.5%) to Bermuda in a contentious tax avoidance scheme.

All this may help explain why, despite additional tax revenue (chart 10) generated from US companies setting up shop in Canada, Canada continues to lose jobs and market share: because jobs do not move and neither does investment.

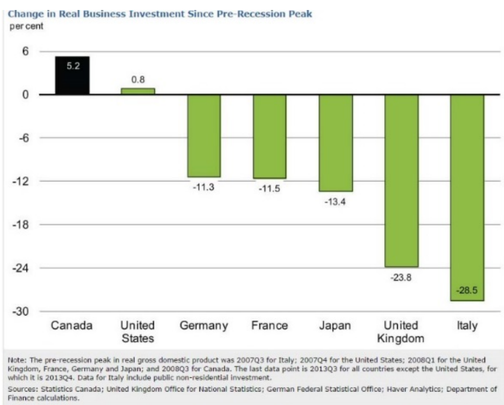


Chart 9, Source: Government of Canada

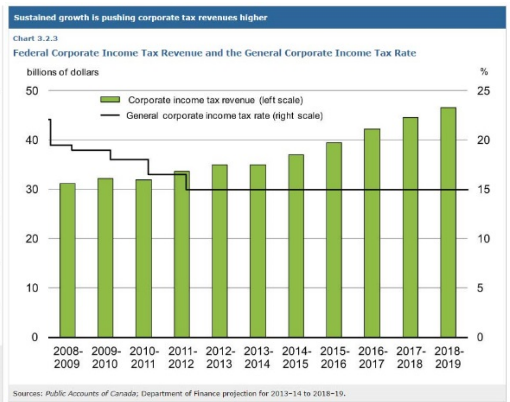


Chart 10, Source: Government of Canada

Dutch Disease

Some might argue that Canada's inability to compete is a consequence of the "Dutch disease" or the "resource curse." (Friedman, 2005) As Friedman puts it: *Dutch disease refers to the process of de-industrialization that can come about as a result of a natural resource windfall.* The term Dutch Disease was coined the early 60s, where it was argued that resources caused the value of the Dutch currency to rise. This in turn had an impact on exports and also made imports appear cheaper. This would explain Canada losing 600,000 manufacturing jobs despite offering one of the lowest corporate tax rates on the planet. As an example to show how a resource based economy actually makes Canada less competitive, data on foreign investment can provide some clues. 20% of foreign investment is concentrated in the natural resource industry vs 22% for all other manufacturing, not including petroleum and coal products manufacturing, which comprise 8% of manufacturing jobs.[7] Considering that jobs in the resource sector amount to 2.3% of the total work force, 2.5% the size of the service producing sector and 20% of manufacturing, it does appear to detract from other sectors.

Added impact of Canada as a reserve currency

Compounding effects of the resource curse, it should be noted that Canada has become a reserve currency and now holds $127 billion (USD) or about 7% of GDP in reserves. Funds, held mostly by China.

The reason becoming a reserve currency exacerbates the resource curse problem in Canada is because reserves are also known to strengthens currency, adding to the impact of lower cost imports and less competitive exports. Also economic stress can be hidden because government can fund its budget using borrowed money.

[7] Source Foreign Affairs, Trade and Development Canada

The mechanics are as follows: reserves are typically invested by foreign sovereigns in highly rated government bonds and bills, and may also include other securities issued by government agencies or sub-sovereign levels of government. Some reserves managers have also diversified their holdings to include equities. (Lukasz Pomorski, 2014)

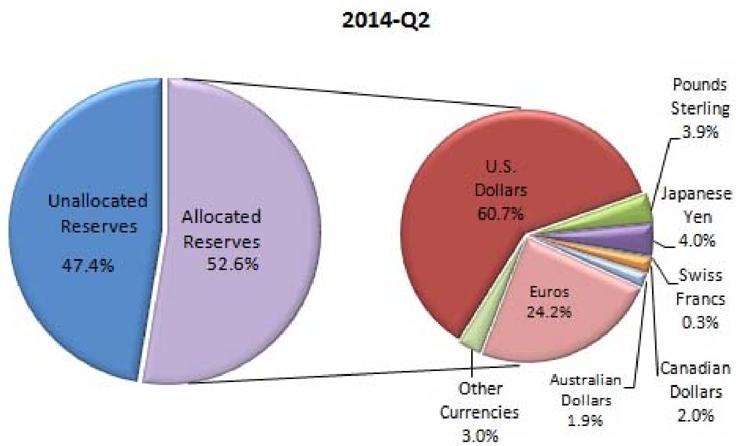


Chart 4, Global currency reserves

The Economist cleverly describes the relationship between China and the U.S. as vendor financing. (Economist, 2014) The problem according to the Economist, is that this may have encouraged the rich world to use borrowed money (the reserves) in order to drive ongoing consumption rather than investment. The Economist calls this "artificial" growth. Here is an extract from the article:

> *"The Holy Grail of Macroeconomics", refers to a debt-financed boom as "cherry-blossom" economics. He recounts the tale of the two brothers who bought a barrel of sake to sell to revellers at Japan's cherry-blossom festival. But instead of taking money from the thirsty crowd, each brother charged the other for a cup of sake, then used the proceeds to buy a cup for himself, and so on. The brothers ended the day drunk and empty-handed.*

The metrics comparing the financial indicators between Canada and the US since Canada became a reserve currency follow:

- Before the credit crunch U.S. financial service industry generated 35% of GDP vs 7% in Canada.[8]
- Since 2012, Canadian reserve currency (claims on Canadian dollars) went from zero to $127 billion USD, equivalent to about 7% of GDP[9] vs U.S. $6.3 trillion USD 37.5%
- Canadian National debt $642 billion = 32.7% of GDP[10] vs U.S. national debt $17 trillion USD = 103% of GDP. This does not include other debt from personal, corporate, or municipal.
- Now add to this the fact that 49% of houses in Canada valued at $1 million plus were purchased by foreign buyers. (Sibthorpe, 2013)
- US (2007) 177% vs Canada's 163% debt to income ratio. (Shmuel, 2013)

To recap, Canada's tax based growth strategies, especially money given to the dying auto sector has not improved its ability to compete, as the proceeding figures show.

[8] Statscan
[9] Claims on Canadian dollars - Currency Composition of Official Foreign Exchange Reserves (COFER) & World Bank
[10] http://www.nationaldebtclocks.org/debtclock/canada

Irrespective of the effectiveness of Canada's economic strategies, the concern is that, even if the tax incentives were driving growth, with Oil prices nearing $80 a barrel, the possibility of the inversion tax windfall ending, and tax revenue from jobs dwindling, offering the lowest corporate taxes may no longer be sustainable, which means more efficient or less costly alternatives are required.

Considering the last two threats to funding the present government spending addiction, in order to continue spending in this manner would mean growing Canada's reserve currency. The implication being indebtedness to China. If a special report that appeared in the Economist is to be believed, that, 'Europe may now be realizing that debt transfers power from the borrower to the creditor': No wonder Canada's leaders are jittery.

Canada-China treaty

China owns Canada's currency reserves which are equal to about 7% of GDP. Canada has also recently signed a treaty with China. A pact which some commentators consider to be too one sided. (Francis, 2012) China are salami[11] strategists according to US officials. Which explains 300% GDP growth over the past 20 years. For some insight into its strategic pedigree, consider one of its most notorious intellectual contributions, 'The Art of War,' an ancient Chinese military treatise attributed to Sun Tzu, a Chinese General, dated 544–496 BC. Here is an extract:

> *Sun Tzu considered war as a necessary evil that must be avoided whenever possible. The war should be fought swiftly to avoid economic losses: "No long war ever profited any country: 100 victories in 100 battles is simply ridiculous. Anyone who excels in defeating his enemies triumphs before his enemy's threats become real".*
>
> *Sun Tzu emphasized the importance of positioning in military strategy. The decision to position an army must be based on both objective conditions in the physical environment and the subjective beliefs of other, competitive actors in that environment. He thought that strategy was not planning in the sense of working through an established list, but rather that it requires quick and appropriate responses to changing conditions. Planning works in a controlled environment; but in a changing environment, competing plans collide, creating unexpected situations.*

Getting a seemingly one sided, 31 year treaty with Canada certainly seems like a strategic victory. Another example of China's calculated strategies is expressed by US officials with respect to the dilemma over China's claim in the South China Sea. According to the Economist:

> *In Washington, the bitterness over what US officials saw as an exercise in bad faith on the Chinese side is informing the fierce debate within the Obama administration about how to respond to what are often described as China's "salami-slicing" tactics.*

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[11] **Salami tactics**, also known as the **salami-slice strategy**, is a divide and conquer process of threats and alliances used to overcome opposition. With it, an aggressor can influence and eventually dominate a landscape, typically political, piece by piece. In this fashion, the opposition is eliminated "slice by slice" until one realizes (too late) that it is gone in its entirety. In some cases it includes the creation of several factions within the opposing political party and then dismantling that party from the inside, without causing the "sliced" sides to protest. Salami tactics are most likely to succeed when the perpetrators keep their true long-term motives hidden and maintain a posture of cooperativeness and helpfulness while engaged in the intended gradual subversion.

In recent months, the US has come to two broad conclusions about its approach to the South China Sea. The first is that its efforts at deterrence are having only limited impact. Despite considerable US attention and rhetoric since 2010, China has slowly continued to shift the status quo in ways that are rattling both many of its neighbours and the US.

The second is that US military strategy in the region has to some extent been asking the wrong question. For several years, some of the Pentagon's best minds have been focused on how the US would win a protracted war with China and have come up with a new concept – known as AirSea Battle – to ensure continued access of US aircraft and ships to contested areas during a conflict. However, the reality is that Washington is facing a very different military challenge, a creeping assertion of control by the Chinese that often involves civilian rather than naval vessels – the sort of grey area that would not normally warrant any response from the US.

"We need to think less about a hypothetical major war and more about the actual situation we are confronting on a daily basis," says a former senior US commander in the region. "It should not be beyond our wits to devise a strategy to outmanoeuvre China."

The military options being considered by the US revolve around collecting more information on Chinese actions – from surveillance aircraft or radar – and increased air and naval operations that will challenge efforts by China to claim control of new areas.

The dilemma for the US is to find ways to raise the costs for China without sparking a confrontation over territories that most Americans would consider a worthless bunch of rocks.

The question that should be asked:

- How much leverage over politics and legal matters will China's support for Canada's reserve currency and resource investment give them?
- How will the treaty improve the Canadian economy? For example, already salami strategies are being applied to loosen labour laws in Canada. According to Nathan Vanderklippe and Brent Jang, China expect policy concessions from the Canadian government or, "many projects will drop," said Feng Zhiqiang, executive vice-president of Sinopec International Petroleum Exploration and Prduction Co., a subsidiary of the Chinese oil and gas giant Petronas.

China risk

Pollution is another worry. According to Kate Galbraith, of Foreign Policy, Nearly one-fifth of China's farmland is polluted, an official government study found in April, and so is three-fifths of China's groundwater. For residents, the most obvious concern is the air: In smog-swamped Beijing, just 25 of 2,028 days between April 2008 and March 2014 had "good" air quality by U.S. standards, according to a *Wall Street Journal* analysis of U.S. embassy air-monitoring data. (Galbraith, 2014) Given these facts, will Canada be able to manage China's environmental threat? The answer according to Gus Van Harten is no. As he says, "The treaty clearly impacts on provincial powers on natural resources, taxation, land and property rights, and other matters. It applies to provincial legislation, regulations, or court or tribunal decisions that affect Chinese-owned assets, with limited exceptions. It does not contain a NAFTA-style carve-out for provincial performance requirements or any carve-outs for provincial measures regarding the treaty's expropriation and fair and equitable treatment provisions. Thus, **there is a real possibility that, over the lifespan of the treaty, Canada will face billion dollar-plus awards due**

to provincial decisions that are not reviewable in Canadian courts. Does your government intend to assume the fiscal risk and have you obtained formal provincial consent for the proposed ratification of the treaty in light of its constitutional implications?" (Harten, 2014)

Considering the Canada-China treaty risk, Canada can likely benefit if it can manage to enforce environmental and labour laws. The problem is that money generated from this alliance will only delay the inevitable: unless Canada can reverse its weakening competitive position by improving its labour productivity our competitive position will continue to erode. The way to avoid this this, according to Robert Dutton, a trainer at L'Ecole d'entrepreneurshi de Beauce (EEB) is to increase productivity by investing in equipment, technology to improve performance, migrating production to added value in the production chain, innovation, and constant improvement in execution. (Dutton, 2014) Dutton's views are directly related to the resource issue and expressed through Dutton's reference to an article published in 2000 by Michael Porter, Professor at Harvard Business School. Essentially, what he is saying is that there are that productivity is the base of prosperity; it is not due to having resources. He sums it up as simply: values, knowledge and know-how.

Conclusion

Housing is the canary in the coal mine and Canada's job situation is the determining factor as to whether it pops or not. We know the consequences if it does. For a reminder, we can look to Janet Yellen, Chairman of the Federal Reserve Bank, who joined other 99% when she said, "It is no secret that the past few decades of widening inequality can be summed up as significant income and wealth gains for those at the very top and stagnant living standards for the majority." (Spicer, 2014) Yikes, when the Chairman of the Federal Reserve starts reading from Rousseau's Social Contract, it is a sign that change is due: hopefully through the electoral process and not a revolution though.

Housing is the canary and oil is the threat. Oil suffocates the Canadian economy, for proof, just read any newspaper to see the result of the $80 barrel. Don Pittis, journalist for the CBC published an article predicting the fall of the Loonie in tandem with Oil prices. He cites an Economist report titled, ***The future of oil: Yesterday's fuel***. In his words: *The Economist article suggests that this is not going to be just a blip but more of a sea change, as global oil demand plunges permanently.* Pittis sees the consequential fall in the dollar this as a net advantage, and quotes the Governor of the BoC: **Poloz who recently pointed out** that the "true" price of the Canadian dollar, (that is, without the impact of oil), will be very good for Canadian exporters. Especially if the U.S. industrial economy continues to recover. On the other hand, he adds, prices might just start climbing again.

Key facts to show government strategy scorecard:

- Oil revenue, low taxes, and Canada's new reserve status have provided government revenue that has been used to reduce corporate taxes. Some industries have used this to make progress, but overall as trade data demonstrates, investment and jobs from this strategy are not necessarily benefiting the Canadian economy;
- 600,000 manufacturing jobs were lost and government reports show Canada to be less competitive and productive as compared to its peers;
- Housing indicators show a market at an inflection point;
- Oil revenue, tax revenue, the US closing of US corporate inversion tax loopholes will mean less money to fund Canada's programs;

- China and Canada have a treaty in place and Chinese firms are throwing salami slices at Canada's regulations, demanding loose foreign worker policies, expecting weak environmental laws.

Evidently playing with taxes, although considered "satisfactory" by video game developers, is an inefficient driver for economic competitiveness as trade data has revealed; especially tax inversions. Shining light on companies like Google and Apple show them to be friend to no country.

The alternative approach, demonstrated by Canada's financial service sector is replication of the strong, government led regulatory environment, shared services and infrastructure support. The latter exemplified by Interac, CPA, CMHC, CDIC, and shared IT costs for credit unions (Celero). Applied to the video game segment, this could mean sharing powerful, secure servers, software, and pooled, subsidized research money for specialized advanced technology (software) development.

As Dutton says (page 18), investing in equipment, technology to improve performance, migrating production to added value in the production chain, innovation, and constant improvement in execution. Just add shared to this and maybe we can afford it without borrowing from China.

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