TD Bank Financial Group

TD Economics

Special Report

September 1, 2009

THE ROAD TRAVELLED AND ROAD AHEAD

An update on the Québec economy

More than two years have passed since we published a comprehensive report on the Québec economy entitled *Converting Québec's Strengths into Prosperity*[1]. We highlighted that the province possesses enormous assets and potential, including a well-diversified economy and a high quality of life. But despite these strengths, we argued that demographic and other longer-term shifts represented a greater threat to Quebec's future prosperity than other large economies in Canada. Accordingly, the report urged bold action on many fronts in order to prevent a further widening in the so-called "prosperity gap" against the rest of Canada.

Given the flurry of developments that have taken place since then, we thought an update to the report was warranted. The global economic and financial boom that had been underway earlier in the decade has given way to bust. Longer-term growth prospects for the U.S. and world economies have now been put under question and protectionist sentiment has re-emerged. The Canadian dollar and crude oil prices have seen massive gyrations and are now widely expected to hold at a higher level than was believed two years ago. Balanced budgets have been replaced by structural deficits. Put simply, the economic landscape has been altered dramatically.

On a plus note, Québec's diversity strength has stood its economy in good stead over the past two years. As other large provincial (and U.S. state) economies have floundered badly, production and employment in Quebec have proven relatively resilient.

This has allowed the province to make up some lost ground in its relative per-capita income since 2007. But underneath this silver lining, the daunting challenges in the way of further narrowing the prosperity gap still loom ahead. And, as noted, new ones have been created.

With recession fears abating, it will be crucial for the province to recast its focus on addressing these longer-term challenges.

HIGHLIGHTS

- **The Quebec economy is holding up relatively well in the current recession, especially compared to its peer large provinces (Ontario, Alberta, B.C.)**
- **The demographic outlook and labour force participation have improved since our 2007 report. Nonetheless, a significant headwind will remain as baby-boomers eventually retire**
- **Other key long-term challenges to prosperity such as productivity and competition from the U.S. and emerging market economies remain**
- **Economic policy moves have been tilting the province in the right direction**
- **A new challenge has emerged on the fiscal front. Restoring budget balance within 4-5 years must receive top billing**

The road travelled

Roughly half a year after the release of our study, the credit crunch broke out, which would mark the beginning of the worst global recession in decades. After hitting a peak of US$147/barrel in July 2008, crude oil would plummet to US$30/barrel six months later. Most economies across the country have gone in full blown reverse as a highly synchronized global recession hit Canada's borders. The Canadian dollar plummeted, from parity to US$ 0.77, but since late last year both exchange rate and oil have rebounded as fears have eased.

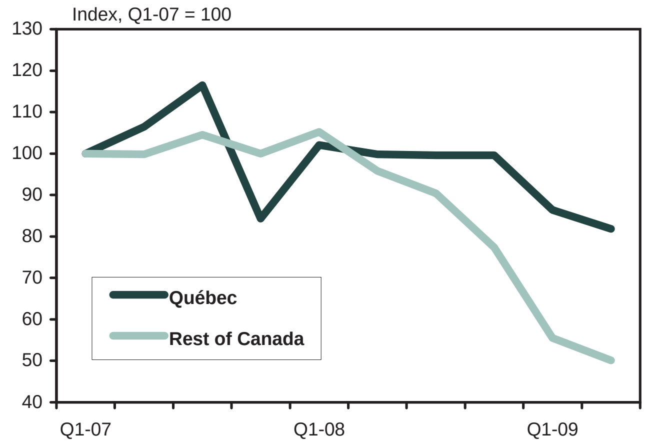
The financial and economic crisis has had a substantial impact on fiscal positions globally. The IMF estimates the fiscal balances of advanced G-20 economies to have deteriorated by 5.9 percentage points of GDP this year followed by 6.2 percentage points next year[2]. The worst of this Great Recession may now be over, but we expect only a slow return back to normal output levels globally.

Meanwhile, the Québec economy would present a picture of relative stability through the major swings in the global economy as well as financial and commodity markets. While not growing as fast as the rest of the country in 2007, the Québec economy picked up a bit of steam in the second quarter of last year, growing at a 2.0 per cent annualized rate while the rest of Canada's economy fell flat. It was also one quarter late (Q1-09) in recording its first large contraction in real GDP vis-à-vis the rest of the country (Q4-08). Its labour market has held up relatively well, with employment off by 1.8 per cent since October 2008 whereas employment in the rest of Canada has fallen by 2.6 per cent.

The recent outperformance has been supported by more balanced housing markets and an important public infrastructure spending program well under way before the recession hit. While construction and resale housing market activity is much below that of a year ago, the decline has not been as steep as in Ontario and western provinces. Furthermore, existing home prices have not fallen off, thereby providing more support for household consumption – through the absence of a negative wealth effect that occurs when home values decline. The introduction of a massive ($30 billion over 2008-13, since then boosted to $42 billion) public infrastructure spending program announced in 2007 also meant that many public works projects were already under way or "shovel ready" as the recession hit.

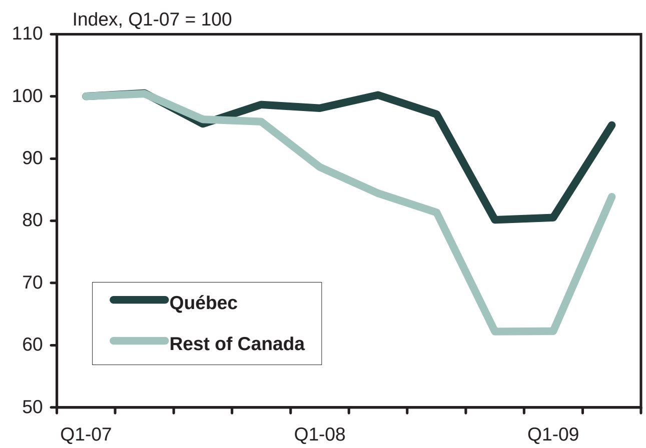
Structurally, the outperformance is largely owing to the province's diversified economic base. While more manufacturing oriented than any other province[3], it has a diverse factory base that has already gone through earlier major structural change. Its textile, leather, and clothing industry was decimated at the turn of the century as emerging market competition and a rising Canadian dollar eroded its competitiveness. Meanwhile, its forestry sector has been downsizing since the beginning of the U.S.

HOUSING STARTS



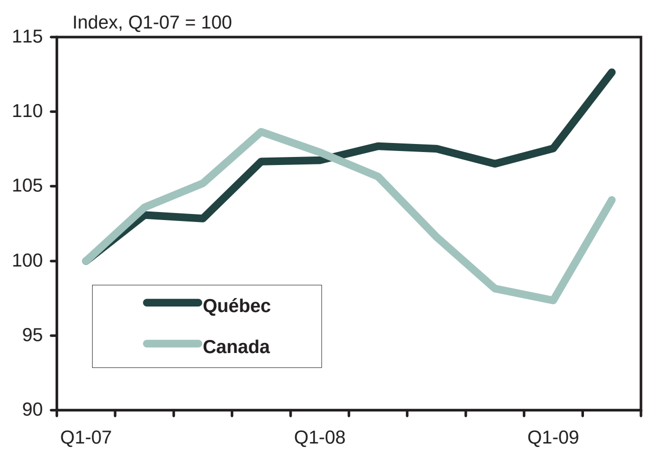
Source: Canada Mortgage and Housing Corporation

EXISTING HOME SALES



Source: Canadian Real Estate Association.

AVERAGE EXISTING HOME PRICE



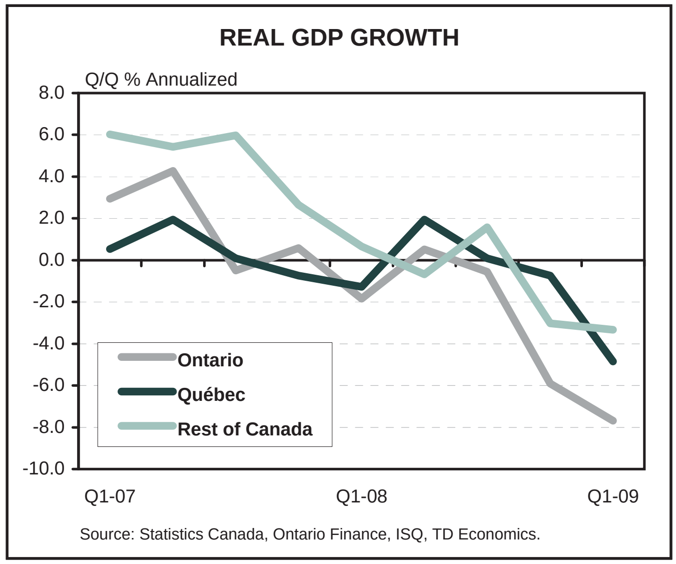
Source: Canadian Real Estate Association.

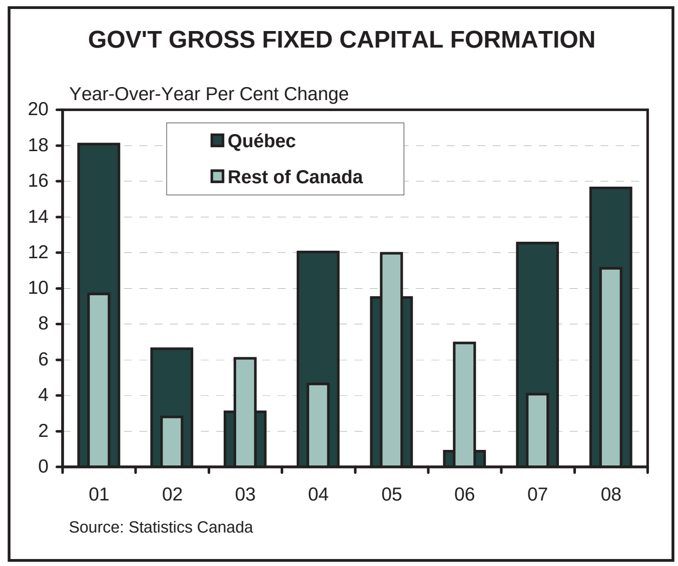
housing starts downturn in 2005 while its pulp & paper industry has been faced with structural challenges in the North American print media market that have only been exacerbated by the current recession and financial market woes. As a result, on the goods-producing side, Québec's economic base has become more reliant on industries such as aerospace & parts, primary and fabricated metal products, machinery, and chemical manufacturing (e.g. pharmaceuticals).

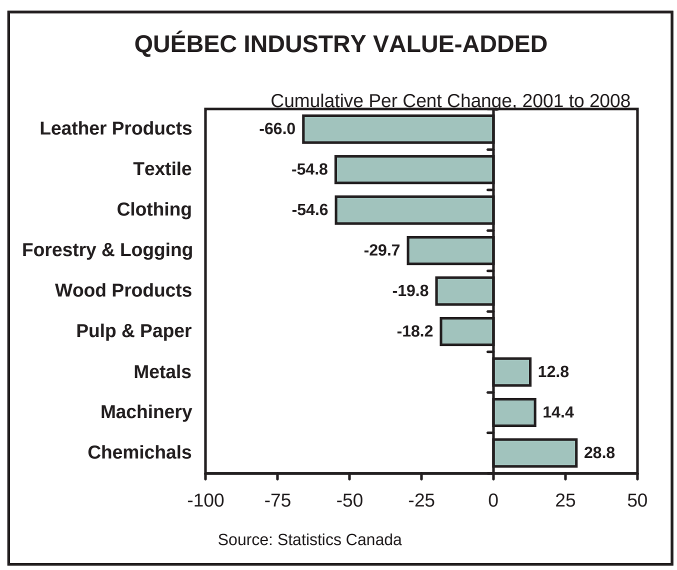
Furthermore, the province currently has little exposure to the automotive industry, aside from sales and auto dealerships. And while more resource-oriented than Ontario, it is far less resource-dependent than the western provinces[4]. The diversity also extends to its private service sector, which is well represented in finance, insurance, real estate, information and cultural industries, and professional and business services.

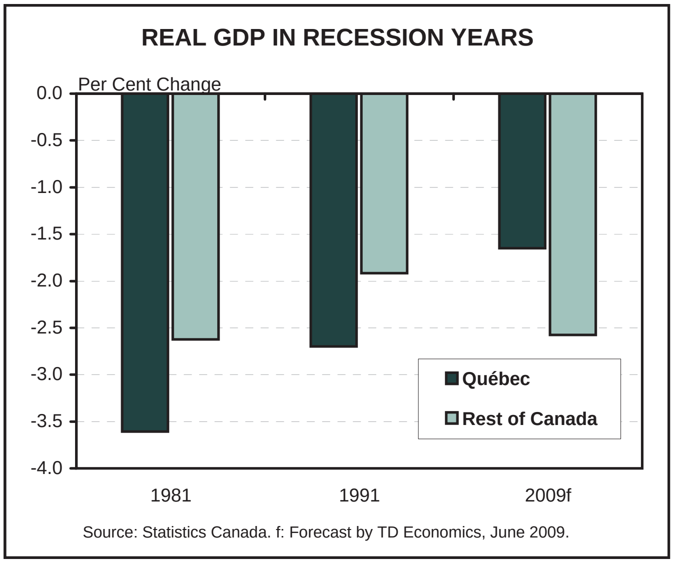
This is not to say that Québec has not suffered a recession. There is also reason to believe that some of its impacts will be felt in delayed fashion, especially in the labour market as suggested by July's dismal employment figures (-37,000 or -1.0 per cent) – the worst monthly drop since November 1992. The unemployment rate in the province's economic hub, Montréal, has surged by 2.2 percentage points since October 2008 to 9.6 per cent in July. The jobless rate for the entire province hasn't fared much better, increasing by 1.8 percentage points during this period to 9.0 per cent in July. We expect the labour market will remain weak overall next year, with the unemployment continuing to trek towards 10 per cent in the first half and some persistence at a relatively high jobless rate in the second half. The strong Canadian dollar could also compromise any export-led recovery, not to mention that we expect the U.S. recovery to be relatively sluggish. A return to normal annual growth rates is not likely until 2011, with a return to potential output to come even later. While having avoided a major correction as of yet, Québec's housing market should remain sluggish under such a weak economic backdrop, with home prices moving mostly sideways for the remainder of this year and into next year. A detailed economic forecast is provided in our latest *Provincial Economic Forecast*[5].

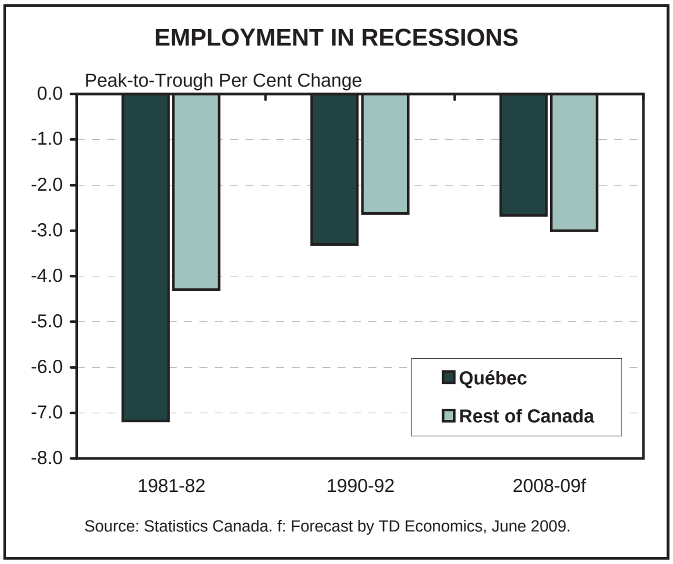
Despite the storm clouds that remain, the return to growth in Québec later this year will mark the end of a relatively short and shallow recession compared to those experienced in the early 1980s and early 1990s. More specifically, the recession is poised to last 4 quarters. By

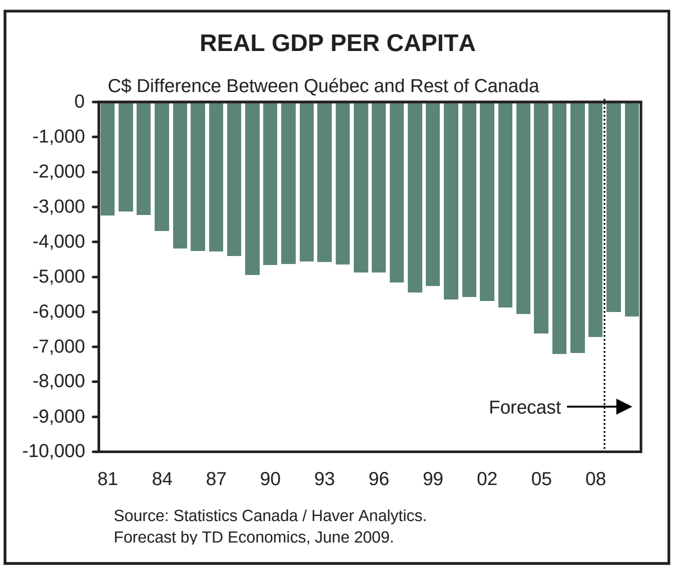












comparison, the previous two recessions of the early 1980s and early 1990s lasted 6-8 quarters. And while the current recession has been brutal in some parts of the country, most notably Ontario, Alberta, and B.C., Québec has so far managed to sidestep the worse. We estimate the peak-to-trough output change will be -2.3 per cent for Québec and -3.6 per cent for the rest of Canada. Job losses will likely total around 110,000 (or 2.8 per cent), less the past two recessions, which saw peak-to-trough employment losses of 3.3 per cent (1990-92) and 7.3 per cent (1981-82).

The road ahead

While Québec will emerge from the recession less battle-scarred than most North American economies, the province still faces its fair share of medium and longer term challenges. In particular, in our 2007 study we pointed to the gap in standard of living between Quebec and the rest of Canada, which was estimated at $6,300 per person[6]. Since 2007, there has been some good news with respect to the gap. As a result of its economic track record over the last two years, combined with slower population growth, Québec has managed to halt a trend increase in its real income per capita gap against the rest of the country – a trend that had taken hold from 2001 to 2006.

As of 2008, this gap had retraced back to roughly the $6,700 level of 2005. Furthermore, we expect aggregate real income in Québec to shrink less (-1.7 per cent) than in the rest of the country (-2.6 per cent) this year. Its population should also expand less (0.9 per cent) than that of other provinces combined (1.3 per cent), with the net result that the gap would be closed further, down to roughly $6,000 per person. However, much of this newfound convergence is due to Ontario's difficulties. Admittedly, this is not the kind of convergence – in the midst of a recessionary decline – one would hope for. Nonetheless, recessions happen, and the ability to withstand them better matters for an extended period of time.

The main challenges to closing the prosperity gap remain, however. In 2007, we pointed to labour force, productivity, competition from the U.S. and emerging economies as major challenges to Québec's future prosperity. As we dissect below, these challenges remain largely intact – although some have arguably been brought down a notch (e.g. labour force) while others may well have intensified (e.g. foreign competition, productivity). New challenges have also surfaced, like the presence of a fiscal deficit that will have to be reined in over the next five years.

Labour force challenge

In 2007, the projection was that Québec's labour force would start shrinking in 2013. Certainly a bit of good news since our initial report is that population, according to the latest baseline scenario[7] from the *Institut de la statistique du Québec,* is now expected to be larger over the next quarter century than was projected in 2003. When compared to the previous projection, the improved demographic outlook is largely accounted by stronger net migration (30,000 per year versus 19,000 per year) and a higher fertility rate (1.65 versus 1.50). Lower mortality and higher life expectancy between 2001 and 2006 than initially estimated also provides a higher population starting point in 2007.

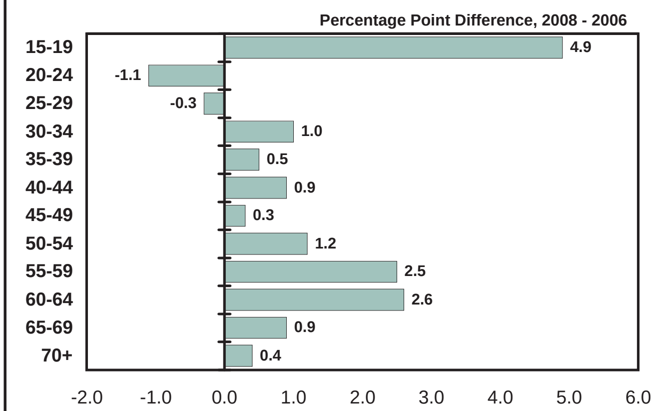
Using these most recent demographic projections for the province and updating labour force participation rates by age groups to match the most recent annual values (2008) provides us with an updated labour force projection. Participation rates have increased significantly, across a broad range of age groups (10 out of our 12), from the 2006 values used in our 2007 report. The most significant jumps in participation came from the youngest (15-19) and older (55-64) groups. Participation among the 15-19 years old, while volatile, has managed to leapfrog ahead of the rest of the country. Unfortunately, participation rates among cohorts aged 50 and older remain substantially lower, and the gap has actually widened since 2006 among cohorts aged 60 and over.

These developments, important in providing a relief valve against rising dependency ratios, are consistent with ongoing changes in retirement profiles and can reasonably be expected to continue into the next decade. To take a conservative approach, however, and better compare with our labour force projection from 2007, we fix participation rates at their 2008 values.

The end result of combining the updated demographic and participation data is a significant near-term boost to the size of the labour force. Importantly, however, this only pushes out the decline of the labour force by one year – now projected to begin in 2014 instead of 2013. The most significant impact of the new projection is to soften the contraction in the 2015-2024 decade and stabilize the labour force from 2025 onwards. Over the quarter century 2006-2031, the Québec labour force average annual growth rate is now projected to be just slightly positive at 0.05 per cent, compared to the -0.13 per cent projected in 2007.

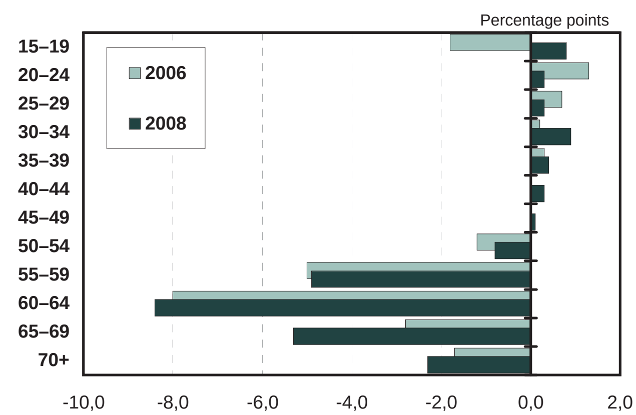
Assuming participation rates continue on their current

CHANGE IN QUEBEC LABOUR FORCE PARTICIPATION RATES, BY AGE GROUP



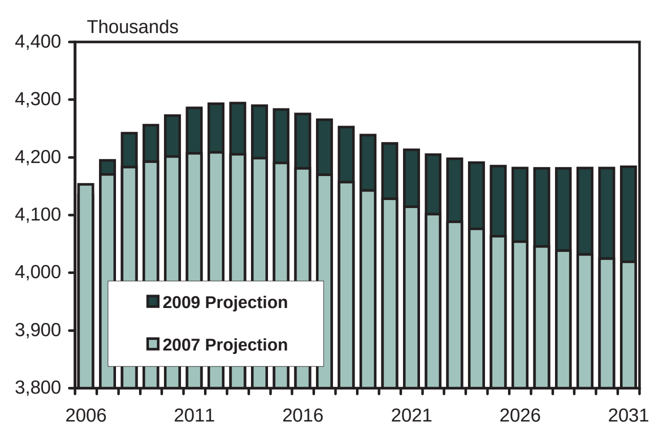
Source: Statistics Canada.

DIFFERENCE IN PARTICIPATION RATES BETWEEN QUEBEC AND CANADA



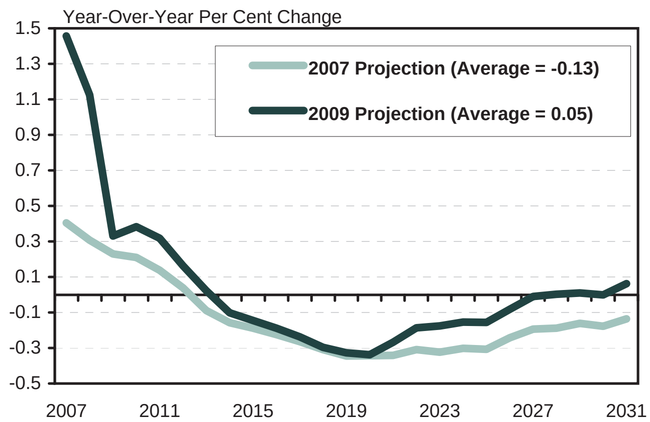
Source: Statistics Canada.

QUÉBEC LABOUR FORCE PROJECTIONS



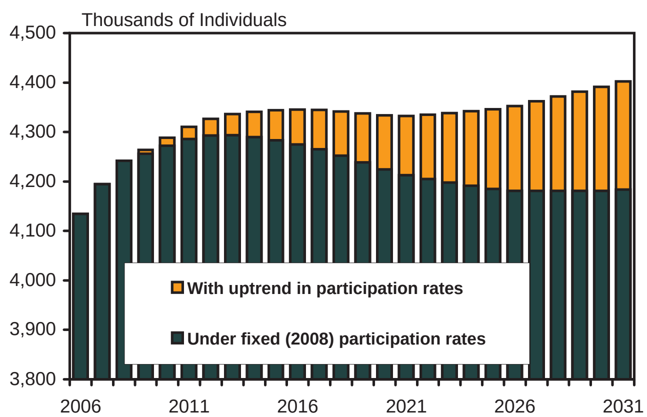
Source: TD Economics, based on projections from Statistics Canada and Institut de la statistique du Québec.

QUÉBEC LABOUR FORCE



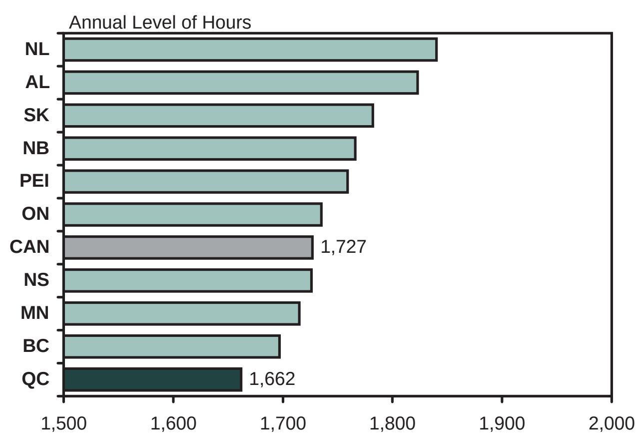
Source: TD Economics, based on projections from Statistics Canada and Institut de la statistique du Québec.

QUÉBEC LABOUR FORCE PROJECTIONS



Source: TD Economics, based on projections from Statistics Canada and Institut de la statistique du Québec.

HOURS WORKED PER JOB (2008)



Source: Statistics Canada

uptrend for a while before eventually reaching a ceiling (e.g. to 90 per cent among the core 30-49 age group) would push out further by 4 years the expected decline of the labour force, to 2017. Under this scenario, benchmarked to a Statistics Canada labour force projection[8], Québec's labour force would start growing again, albeit modestly, by 2022 – which is when the currently higher fertility rate starts to have an impact on the size of the working age population. This would provide some relief to demographic pressures by boosting annual average labour force growth from 0.05 per cent to 0.25 per cent. However, the latter should be compared to a similar evolution towards higher involvement in the labour force across the country, not solely in Québec, and would not likely place the province in any significantly better relative position.

It is nothing new that demographics and participation rates have been, over recent decades, more favourable to trend economic growth in Ontario and the rest of Canada than in Québec. While the recently improved labour force projection provides the province with slightly more breathing room, we note that the rest of Canada's – let alone the United States' – relatively favourable position in this regard is not eliminated, even after taking into account Québec's recently improved demographic outlook. Our 2007 labour force growth projection for Canada as a whole averaged 0.30 per cent over 2007-2031, higher than the upgraded outlook for Québec, and improves slightly to 0.32 per cent if updated with more recent (2008) participation rates. The aging of baby-boomers, a higher median age and lower participation rates among older cohorts in Québec compared to elsewhere in the country will remain as dominant headwinds facing the province over the next 25 years.

Hours worked: low and declining

While a trend decline in aggregate hours worked is not specific to Québec, the province still records the lowest level of annual hours worked per job among provinces.

Our 2007 report found that over 60 per cent of Québec's prosperity gap vis-à-vis the rest of Canada was attributable to fewer hours worked. To the extent that some of this difference might be dictated by individual schedule choices that trade off earnings and work time in favour of leisure (or non-market) time, this need not be alarming. But Québec had the same proportion - 18 per cent as of 2008 - of workers holding part-time positions as Canada. Furthermore, the share of part-time work deemed voluntary was also the same, at 77 per cent. This lends little support to the notion that invidividual choices and/or different social conventions lie behind the fewer hours worked. To the extent that they result from labour market rigidities that lead to narrower opportunities, this should be cause for concern. Importantly, the gap in annual hours (65 hours, or 3.8 per cent, in 2008) worked per job between Québec and Canada shows no sign of receding on a trend basis – to the contrary it doubled from 36 hours in 1997 to 72 hours in 2007. Unless these fewer hours are offset by higher labour productivity – the driving force behind wages – there can be no hope of ever closing the prosperity gap.

Productivity challenge

We have long identified increasing productivity as the single most important challenge facing the Canadian economy[9], and Québec is no different in that regard. Assuming historical trends remain intact, the economy's potential output[10] will slow due to weak productivity and slower– and likely negative in the case of Québec from 2014 to 2027 – labour force growth.

While the labour force projection has improved since 2007, the unfortunate fact remains that expansion of the labour force cannot be expected to fuel significant economic growth over the next quarter century. Adding a reasonable trend increase in participation rates by age group to our projection only translates into annual average labour force growth of 0.25 per cent over the next 25 years.

This leaves productivity gains as the main engine of economic growth. Recent trends on this front are not encouraging, but could productivity still save the day? Views abound on what the future holds, from the notion that an older workforce tends to be less productive (e.g. fewer young entrepreneurs and innovation) to that which holds that the scarcity of qualified labour will magnify its productivity through investments in labour's capital complements.

Rather, we can easily back out what assumptions on productivity would be required to maintain real output growth on its historical trend. Québec's real output (GDP) has grown at an annual average rate of 2.6 per cent over 1998-2008, which can be roughly decomposed into labour force growth of 1.4 per cent and labour productivity (output per worker) growth of 1.2 per cent. The straightforward implication is that under a range of annual average labour force growth of 0.1-0.3 per cent over the next 25 years, and little structural change in unemployment, productivity gains would need to be in the order of 2.3-2.5 per cent per annum in order for real GDP growth to match that of the last ten years. Such a performance is not inconceivable, as evidenced by the 1994-2000 export-led productivity boom during which labour productivity growth in Québec was 2.5 per cent per year. However, more recent trends suggest it is unlikely. Indeed, the growth in output per worker would need to double from that recorded over the last decade.

Assuming productivity gains over the next 25 years are no better but no worse than during the last decade, Québec's real output can be expected to grow by an average of 1.3 to 1.5 per cent annually. Translated into per capita terms, our projection implies real income would grow at 0.9-1.1 per cent per annum, compared to the 1.9 per cent of the last decade.

In addition, there remain important downside risks to productivity, even vis-à-vis the dismal record of the past decade. There is little reason to believe that important pillars of past competitiveness, for the manufacturing and export sectors in particular, such as cheap energy and a weak Canadian dollar, will not continue to erode.

With the U.S. dollar under cyclical, if not structural, pressure to depreciate on a broad basis and the loonie likely to continue receiving a lift from any uptrend in global commodity prices, any currency advantage is likely to be fleeting. It looks more likely, therefore, that Québec exporters will have to continue competing over the long haul in a high Canadian dollar environment.

Québec also has to contend with increasingly important players on the global export stage, emerging markets economies, which are climbing up the value-added chain. And while the severity of the U.S. recession and fiscal pressures stateside might suggest impaired competitiveness from U.S. firms over the next decade, it is far from clear that U.S. exporters might not emerge stronger than ever. To the contrary, many – including us – have suggested that U.S. recovery will be export-led[11]. Recall that U.S. export volumes were going through a 5-year long boom before the current recession, and that a relatively weak U.S. dollar will bolster their competitiveness going forward. Trade is not a zero-sum game by any means, but in vying for emerging market demand – which will only continue to grow in relative importance – against U.S. supply, Canadian and Québec exporters will face formidable competition.

A continued erosion of the export-oriented manufacturing sector is more likely than not. As a percentage of total employment, manufacturing will not return to the 18-20 percent of the 1980s and 1990s. As such, an important source of labour productivity (output per hour) growth – 2.4 per cent over 1997-2007 compared to 1.8 for all industries combined – is waning. Furthermore, on a comparative basis, Québec business investment in machinery & equipment – which feeds productivity gains – has matched the rest of Canada over the long-term record (1982-2008) but has slipped over the last decade, expanding a full percentage point slower than in the rest of the country.

Among other consequences, slower potential output will translate into slower growth in the government's fiscal base, and thereby heighten the need to compress its spending growth in line with that of the overall economy.

Prosperity agenda

As difficult as they may be to tackle, many challenges also represent a window of opportunity for the province. A looming demographic and labour force crunch puts a heightened focus on the importance of immigration, labour mobility, and education. Continued pressure from international competitors holds the promise of higher productivity for exporters who succeed and expand.

A highly synchronized global recession highlights, especially for a small economy, the importance of securing market openness in the face of protectionist pressures, and provides an opportunity to reaffirm and expand free-trade deals. Cheap financing costs and an economy with sizeable excess capacity, while in the midst of a recession, provides a favourable setting to renew government capital expenditure plans, particularly long overdue investments in public infrastructure. The pressure to reduce man-made greenhouse gas emissions and price-in a range of environmental concerns is bound to increase the cost of producing and using fossil fuels and consequently shift demand in favour of clean power generation – for which the province is well positioned.

While it has only been two years since our report was published, now is as good a time as any to review the progress, or lack thereof, which has been made since then in the key areas we identified:

- Pursue free trade
- Tackle the infrastructure deficit
- Improve the business environment
- Strengthen the macroeconomic climate
- Shift tax mix towards consumption
- Remove disincentives to work
- Reduce regulatory burden
- Support post-secondary education
- Work to integrate immigrants
- Give cities adequate tools
- Parsimony in non-priority spending

Needless to day, the recession has been a major distraction for policy makers. With the recession now easing, there is no better time to set the eyes back towards the long-term horizon. We discuss below notable areas of improvement, while other areas have been more wanting.

Foreign competition and trade

The knocking down of barriers to facilitate labour mobility, secure and expand market access, most especially where our exchange rate against the U.S. currency puts us at no particular disadvantage (e.g. inter-provincial trade, Euro-area) is essential and at no cost to public treasuries. After a long spell without the signing of any bilateral deals since a 2001 accord with Costa Rica, Canada signed an agreement with a small block of four European countries (Liechtenstein, Norway, Iceland, and Switzerland), which came into force on July 1. Québec clearly grasps the trade openness challenge, and has been active towards secured and expanded free trade, within Canada itself (across provinces), with the U.S. as well as Europe. In a first-ever joint meeting of Ontario and Québec cabinets in June 2008, the two provinces released a framework for negotiating a comprehensive agreement on trade and economic cooperation. This is expected to cover labour mobility, energy, transportation, public procurement, and food products. Leading by example, in part to afford protection against "Buy American" measures emanating from the U.S. Congress, Québec recognizes the need to extend free-trade procurement provisions to provincial and local governments. Trade negotiations, albeit in their initial stages, are also underway with the European Union. In the trade and mobility arena, we can only urge the government on, and welcome its vision of a "new economic space" for Québec.

Renewing public infrastructure

Six months after our April 2007 report, the provincial government unveiled a massive public infrastructure program, initially slated at $30 billion over five years, with 80 per cent of the spending towards asset rehabilitation. A large portion of the province's public infrastructure, such as roads, public transit, education and health care facilities, was built in the 1960s and 1970s, and needs to be rehabilitated. The plan was subsequently boosted and some expenditure was brought forward in light of the economic downturn. The Québec infrastructure plan is now projected to total nearly $42 billion from 2008 to 2013. Furthermore, according to a Canada-Québec framework agreement, Québec is estimated to receive a $2 billion federal contribution from the Building Canada Fund. The renewed attention at all levels of government accorded to the maintenance and expansion of our public infrastructure was long overdue. If maintained as planned or further expanded, large-scale investments towards a modern, up-to-date, and energy-efficient public infrastructure can potentially turn a productivity, health, education, business logistics and labour mobility disadvantage into a competitive advantage.

Business environment

While there remain a slew of complicated and sector-based tax credits and subsidies, a major step was taken in phasing out capital taxes by 2011. Capital taxes for manufacturers were eliminated earlier, in the 2008 Budget. Capital taxes represent a clear disincentive to capital investments such as machinery & equipment, which are crucial to boosting productivity. Québec will now stand with other provinces in having no such impediment on non-financial institutions. Furthermore, in phasing out its capital taxes on financial institutions by 2011 alongside Ontario, it will put pressure on other provincial jurisdictions to follow suit and level the playing field. In the interim, Québec will benefit from an advantage vis-à-vis Atlantic economies, which still levy significant (4-5 per cent) capital taxes on financial institutions. By 2012, the province's overall marginal effective tax rate (METR) on business investment is set to remain competitive against that of the other three large provinces, even after factoring in sales tax harmonization in Ontario and B.C.

Meanwhile, the general corporate income tax (CIT) rate remains at 11.9 per cent. As of July next year, Ontario's CIT rate will come down to 12.0 per cent. Ontario plans a further reduction down to 10.0 per cent by 2013. Lowering Québec's CIT rate by the nearly 2 percentage points then needed to match Ontario's will be a priority. New Brunswick has shown the way by taking an even more aggressive approach than the 10 per cent rate, and plans to lower its CIT rate to 8.0 per cent by 2012. The ability of the provincial government to provide further business tax relief is inevitably intertwined with the outlook for the economy and its fiscal balance sheet, however.

Fiscal challenge

While the government achieved budget balance until last fiscal year, the recession has given way to a new challenge in the form of a deficit – much like in every other jurisdiction across the country. Most of the shortfall is a "passive" deficit that comes in the form of lower corporate income tax receipts as a consequence of the recession. While boosting its infrastructure spending and capital expenditures, the government was careful not to boost its program spending too much amidst calls for a large stimulus program, i.e. a large "active" deficit.

Since our 2007 report was published, the government has taken a variety of initiatives to improve the taxation landscape. It has provided a modest amount of personal income tax relief, is phasing out its capital tax, has started inflation-indexing many government services user fees, and will hike the TVQ (provincial value-added tax) by one percentage point in 2011. The latter measure, while initially generating more revenue rather than shifting the tax mix per se towards consumption, is nonetheless economically the least hurtful measure to take in the presence of a large shortfall.

As we now look towards the economic recovery, the priority should be to come up with a credible plan to restore fiscal balance by fiscal year 2013-14. Parsimony in non-priority spending will be essential. We would caution against any new initiatives that would boost spending and/or weaken revenues until it becomes crystal clear that fiscal balance is within striking distance.

Meanwhile, the debt burden remains a concern. Québec still has the highest net debt per person burden in the country after Newfoundland & Labrador. Even after recording larger deficits (as percentage of GDP) over the next 3-5 years, Ontario will end up with a much lower debt-to-GDP ratio coming out of this recession (likely below 25 per cent). Québec's debt-to-GDP will approach, if not breach, the 50 per cent mark by fiscal 2013-14. As such, the province is prevented from significantly strengthening its macroeconomic environment, and will have to first show that it can stabilize its debt-to-GDP ratio.

The large gap of unidentified measures in Budget 2009 to bridge the gap by fiscal 2013-14 will not do. This gap grows to $3.7 billion by fiscal 2013-14, according to Budget 2009 – and the outlook has worsened since then. All said, in new Finance Minister Bachand's 2010 Budget we expect to see much needed spending compression and revenue generating measures to fill the large gap.

The energy advantage

The case for higher longer-term fossil fuel prices is more sensible than the alternative, with arguments ranging from constraints on the supply-side to continued strong demand from emerging economies, to the pricing-in of environmental impacts and concerns. Clean energy generation has never been more needed, and Québec can play a pivotal role in the reduction of greenhouse gas emissions in North America. Hydro-Québec plans to expand production capacity with the following ongoing major projects: Eastmain (893 MW, near-term, complete by 2012), wind farms (3,500 MW, medium-term, by 2017) and La Romaine (1,500 MW, long-term, 2020). Meanwhile, with Ontario's coal-fired generated power phase-out to be completed by 2014, that province turns to the next challenge – the phasing-out of existing nuclear facilities as they come to the end of their productive life by 2021 to 2034. The replacement need is estimated at 60.4 billion kWh by 2021. Electricity transfer capacity between Ontario and Québec is set to increase by 1,250 MW in 2010 to a total of 2,788 MW. Assuming no further increase in interconnection capacity, Québec exports to Ontario (max. 24.4 billion kWh) could represent 40 per cent of Ontario's required replacement power. Increasing interconnection capacity could further boost Québec exports and provide Ontario with a cheaper alternative (at roughly 9 cents per kWh in 2008) than nuclear (15 US cents per kWh according to Moody's).

Québec is also turning to its other natural trading partner, the United States. Will its exports count towards the reduction of greenhouse gas emissions (GGEs)? It seems the Federal Energy Regulatory Commission (FERC) approves hydro as GGE-reducing, saying a deal with New England utilities (NStar and NorthEast Utilities) will lead to a reduction of 4-6 million tons per year of GGEs. Construction for a Québec-New England (New Hampshire) interconnection could start in 2011, with deliveries slated for 2014 as part of a 20 to 25 year provision contract. This would double Québec's exports to the region. Output for this interconnection will come from the La Romaine project.

As an active participant in the Western Climate Initiative (WCI), Québec has helped set the pace in Canada for clear GGE reduction targets, along with a cohesive national and continental approach. The province has passed legislation, albeit still light on details, to help it move towards a cap & trade system by 2012. Caps would be issued between 2010 and 2015, initially targeting only large electricity-producing companies and major emitters (25,000 tonnes and over of GGEs per year). The second phase, post-2015, would target the transportation and home & commercial heating companies. Lastly, we note that Montréal seems best positioned to host the climate exchange ("bourse du carbone").

Jolting the Québec economy

As fleshed out in prior sections, some measurable progress has been made since we published our 2007 report, and the province will be better for it. However, other jurisdictions are clearly not just standing still. As a result, the large prosperity gap is a continuously moving target. Most challenges identified in our 2007 report are as present as ever, while new ones have surfaced as a consequence of the financial crisis and recession, which will not disappear unless addressed. While multiple policy moves – which we applaud – are tilting the province in the right direction, some old knee-jerk reactions to economic change still prevail among some stakeholders. We therefore reiterate the recommendations made in our 2007 report. The opportunity presents itself in the next provincial Budget to craft a bold Vision 2020.

Some sacrifices will have to be made. Health care cost increases must be brought under control. The government must continuously scrutinize where and how it spends taxpayer dollars to ensure that programs and services pass the litmus test of providing value for money. The view that governments are in a position to provide large subsidies for electricity, tuition, and daycare needs to be replaced by one that better targets assistance to lower income households. The implicit subsidization of large energy users, arguably a regressive tax, must stop. Business and household electricity prices must increase towards market prices – which would have the dual benefit of generating revenues (which could be recycled back as broad-based tax relief) while reducing waste. Financial help for lower-income households is best provided directly through the same channel which in the first place determines which households should need it: the income tax and transfer system. The provision of $7/day daycare to households without regard to family income fails both litmus tests of economic fairness and efficiency. Meanwhile, post-secondary educational institutions should get more leeway in setting tuition fees, provided that merit-based financial help (student bursaries and loans) is well focused to help those in need.

Once fiscal balance is achieved, enough elbow room must be generated to provide broad-based personal income tax relief – an area where Québec still imposes a higher burden.

We urge the government to maintain its positive momentum on the many initiatives discussed in this update. Prior to the current recession, few would have believed Quebec would weather the storm so aptly. Its prosperity gap against the rest of the country has ceased to widen and will in fact shrink in the near-term. However, estimates of future potential economic output suggest it will be a formidable challenge to narrow the gap considerably. Québec has not been immune to the recession, beyond which the major structural challenges we identified in 2007 remain. A new challenge on the fiscal front has also emerged, which will limit its manoeuvring room over the medium-term as balance is restored.

Nonetheless, the setting is ripe during economic recovery to set the province on a better footing for younger and future generations. The risk exists that Québec could take comfort in the relative decline of its main trading partners. Looking at wealth convergence through such a lens would only validate a distorted view of lower expectations.

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END NOTES

1 *Converting Québec's Strengths into Prosperity*, TD Economics, April 10, 2007, available at http://www.td.com/economics/special/db0407_que.pdf .

2 With respect to pre-crisis year 2007. *The State of Public Finances: A Cross-country Fiscal Monitor*, IMF Staff Position Note (SPN 09/21), July 30, 2009, available at http://www.imf.org/external/pubs/ft/spn/2009/spn0921.pdf .

3 Manufacturing output accounted for 18.3% of real GDP in 2008, and a lesser 17.4% in Ontario.

4 The natural resource sector, defined here to include the primary sector – which includes agriculture, forestry, fishing and hunting – along with mining, oil & gas, comprised 2.0 per cent of Québec's real output in 2008. By comparison, in the same year, it made up 1.6 per cent of Ontario's real output and 14.4 per cent of the real output of all other provinces combined.

5 *The Calm After the Storm*, TD Economics, Provincial Economic Forecast, July 16, 2009, available at http://www.td.com/economics/qef/prov0709.pdf .

6 In 2005, expressed in 1997 dollar terms or $6,600 in 2002 dollar terms.

7 *Perspectives démographiques du Québec et des régions, 2006-2056*, Édition 2009. Institut de la statistique du Québec, Juillet 2009.

8 Martel, L. et al., *Labour Force Projections for Canada, 2006-31*, Canadian Economic Observer, June 2007, Statistics Canada.

9 See *Canada's Productivity Challenge*, TD Economics, Oct. 5, 2005, available at http://www.td.com/economics/topic/el1005_prod.pdf and *The Economists' Manifesto for Curing Ailing Productivity*, TD Economics, Sept. 18, 2006, available at http://www.td.com/economics/special/dd0906_prod.pdf .

10 Potential output is a theoretical concept defined as the economic rate of growth that generates neither disinflation nor increasing inflation. It provides a benchmark to gauge the degree of capacity pressures present in the economy at any given point in time. A simple rule or thumb estimates it to be close to the rate of growth of the labour force plus the rate of growth of labour productivity.

For more on this concept, see *A Primer on Potential Output: How a nebulous economic concept affects monetary policy in Canada and the United States*, TD Economics, Nov. 14, 2008, available at http://www.td.com/economics/special/dt1106_potential.pdf .

In its most recent *Monetary Policy Report*, available at http://www.bankofcanada.ca/en/mpr/pdf/2009/mpr230709.pdf , the Bank of Canada estimates potential output growth in Canada to be only 1.1 per cent this year, 1.5 per cent next year and 1.9 per cent in 2011. Provincial estimates of potential output are not provided.

11 For more on this, *U.S. Exports: Rise of the Machines Starring Emerging Markets*, TD Economics, June 1, 2009, available at http://www.td.com/economics/special/ff0609_exports.pdf .