AU COURANT

Economic Council of Canada
Volume 11, No. 2, 1990

Transitions for the 90s

- Two steps forward
- The deficit virus
- New Council members

CONTENTS

Volume 11, No. 2, 1990

Chairman's message 3

FEATURE

The 27th Annual Review: *Transitions for the 90s*

A two-pronged transition 4

Rethinking attitudes and strategies 5

A search for new options 8

A new economic policy framework 10

New Council members 11

Two steps forward 12

The deficit virus 14

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ISSN-0226-224X

Difficult "transitions" – The 1990s

Judith Maxwell

The Council's 1990 Annual Review, entitled *Transitions for the 90s*, highlights three factors that make the Canadian economy difficult to manage.

First, there are big differences in regional economic structure. Ontario, for example, can be running well above capacity, generating strong inflationary pressures, while other provinces are lagging far behind. These regional differences can have positive effects, since the regions can help to stabilize each other, but there is also a possible negative. Overheating in one region, particularly a large province like Ontario, can cause national policies, such as monetary policy, to become restrictive, even though that policy may not be the best choice for other regions.

Second, there are signs of rigidity. Some sectors and regions have had a lot of trouble adapting to the shock waves from the world economy in the 1980s. This shows up in the growth in long-term unemployment, particularly in western Canada. Such rigidity is particularly disturbing, when we consider the incessant pressures for change that lie ahead in the 1990s. With the move to greater integration in Europe, reforms underway in the Soviet Union and Eastern Europe, and the emergence of strong competitors in the Pacific Rim, it seems inevitable that the patterns of world trade will change dramatically in the years ahead. Will Canadians be able to cope with the job changes that this entails?

These rigidities make management of the economy more difficult. For example, when policies attempt to reduce inflation, it takes a long time for firms and workers to respond in sectors and regions that are less sensitive to market forces – in the 1981-82 recession, the peak in wages was not reached until 18 months after the unemployment rate started to rise. These long reaction times make it difficult for monetary policy to curb inflation pressures.

The third difficulty is the fragmented decision-making structures in the public and in the private sectors. Because there are no institutions for joint problem-solving, we are frequently forced to resort to bouts of monetary restraint in order to fight inflation. This, obviously, has consequences for output and unemployment.

These obstacles to economic management are particularly damaging at the beginning of the 1990s, when Canada faces exceptionally tough choices on the immediate direction of economic policy. The federal government is seriously handicapped by a mountain of debt (see the speech on the deficit virus reported in this issue) as debt service continues to swamp all other priorities. Thus, the government has no choice but to continue the battle to control the deficit. In the meantime, the Bank of Canada has been leaning hard against inflation expectations for nearly two years – pushing "real" interest rates even higher than in the credit crunch in 1981. These interest rates make deficit reduction exceptionally difficult, and, because the economy appears to be entering a recession, higher unemployment is in the cards.

The Council insists that we cannot abandon the fight against inflation. It is a vital element of future prosperity. But the Council argues that the Bank of Canada should not be left alone in the fight against inflation. The cost of disinflation can be significantly reduced if Canadians make deliberate efforts to overcome the three difficulties mentioned earlier. In general, this requires a collective commitment by the three social partners – government, business, and labour.

If business and labour become partners in adjustment, workers will be better equipped to cope with job changes. This will achieve the equity goal of reducing long-term unemployment, as well as the efficiency goal of improving our capacity to adapt to new market threats and opportunities. Becoming partners in adjustment involves many changes in the way business and labour interact. The Council supports the idea, for example, of delegating the responsibility for the design and delivery of training programs to business and labour leaders. Also, much more innovation is required within the workplace. Later in this issue you will find a report on a number of case studies of the impact of technological change on the workplace – see *Two steps forward*.

If governments curb their own contribution to the inflation process and *if* wages become more responsive to the business cycle, then the Bank of Canada will find that it has more partners in the process of fighting inflation.

If federal and provincial governments can establish a system for better co-ordinating their fiscal policies, such that provinces with overheated economies take more responsibility for disinflation, then the pressure on federal finances and monetary policy will be reduced.

The underlying message of *Transitions for the 90s* is that Canada needs to work on the decision-making process. We need to set some goals and build pathways to achieve them. If we continue to rely upon the existing technocratic and fragmented approaches to the formulation of economic policy, we cannot achieve the kind of economic performance that we wish to achieve for ourselves and for future generations.

In effect, the inflation-unemployment dilemma which we now face demands that all decision makers search for ways to reduce the inflationary pressures in the Canadian system and to help firms and individuals to adapt to the new patterns of world trade.

A two-pronged transition

As Canada enters the 1990s, it faces extraordinary challenges at home and on the international scene.

To ensure the future prosperity of the economy, Canadians will have to successfully manage two crucial transitions:

- industry and workers must adapt to new markets and to the new trends in international trade; and
- Canadians will have to find new methods for reconciling such national priorities as controlling inflation, reducing unemployment, and curbing the federal deficit.

If Canada is to successfully take on the challenges of the 1990s, governments must rethink and coordinate their economic policies. Canadians, for their part, must agree to change their attitudes and patterns of behaviour, both individually and collectively, in a concerted effort to improve the employment situation in the country.

That is the crux of the message delivered by the Economic Council of Canada in its 27th Annual Review entitled *Transitions for the 90s*, in which it also sets out a number of policy options intended to help Canadians to achieve these objectives.

The changing global situation

Constant change in the world economy promises to have a significant impact on Canada's trade and employment patterns.

One need only look at the sweeping changes unleashed by the economic integration of Europe in 1992, which will create a single market of more than 320 million people. The collapse of the Berlin Wall in late 1989 symbolized the release of powerful new forces that will shape the future development of the world economic system.

The countries of the Pacific Rim, meanwhile, are following in the footsteps of Japan, making significant inroads into the world economy.

The Uruguay Round of GATT negotiations, which is scheduled to conclude in December 1990, will also have profound implications for Canada's access to markets and for the rules that govern international trade.

How ready are Canadians to face these new economic realities? These imposing challenges arise just as economic growth is starting to falter and when Canadians might be tempted to turn inward out of preoccupation with questions of national importance such as the recent failure of the Meech Lake Accord, stormy relations with the country's native people, and so on.

Canadians can not afford the luxury of allowing gripping domestic issues, important as they may be, to blind them to the dramatic changes that will be taking place in overseas markets in the 1990s.

The Council notes that Canada has already taken some steps towards putting its economic affairs in order so as to become more competitive globally, such as the free-trade agreement and the proposed goods and services tax (GST). These two measures are specifically designed to make life easier for exporters and for domestic firms that compete with imported products.

Yet much more remains to be done before Canada will be able to offer a new array of high-value-added goods and services or to export the kind of high-quality products at competitive prices that will allow it to compete successfully in world markets.

The changing pattern of exports and imports since the early 1980s is having a profound impact on the composition of employment in Canada. Jobs are disappearing in the primary and manufacturing sectors and being created in the service sector. While unemployment is no more severe now than in the late 1970s, many workers are now experiencing much longer spells of unemployment than was previously the case. This phenomenon is caused, in part, by social ties, but it is reinforced, stresses the Council in its Annual Review, by government policies intended to preserve a traditional way of life.

"Thus we have been faced with the paradox of an economy charging ahead at full capacity while unemployment rates fluctuated in the 7-to-8-per-cent range," notes Council Chairman Judith Maxwell in the Foreword to the Review.

Yet, during the same period, certain countries managed to control inflation while keeping unemployment rates low. They relied on cooperation among governments, business, and labour unions.

While recognizing that there is no universal model that could be directly transplanted to Canadian soil, the Council endeavours in its Annual Review to learn from the successes of other countries. This can help Canada to forge new attitudes and new institutions that will make the fight against inflation less painful, and allow Canadians to make progress in reducing unemployment at the same time.

The Review Team

The Review was prepared under the direction of Senior Research Director Ross Preston. He was assisted by Deputy Director Jean-Pierre Voyer. Other participants were the Performance and Outlook Group with Richard Roy, Deputy Director, Andrew Burns, Bobbi Cain, Pat Nevin, Haider Saiyed, and Marg Willis; the Unemployment Issues Group with Surendra Gera, Project Leader, Miles Corak, and Sajjad Rahman.

Rethinking attitudes and strategies

"The transition to a more effective economic policy framework can only come about if federal and provincial governments, along with business and labour leaders, are prepared to admit that there is something fundamentally wrong with the way we have tried to solve economic problems in the past."

With these blunt words, the Economic Council of Canada lays bare, in its 27th Annual Review, the shortcomings in the traditional approaches to economic management followed by Canadian governments and sets out some options that will help them to deal more effectively with the twin economic problems of unemployment and inflation.

The Council argues Canadians must make a collective and individual decision to change their attitudes and to embrace change rather than considering it a necessary evil. They must also adopt a more mature attitude by accepting their fair share of the responsibility for developing and implementing the kind of measures that will help Canada to successfully weather the crucial transition to a policy framework suited to the economic realities of the 1990s.

As well, stresses the Council, the various levels of government must strive for better coordination in their efforts. Business, too, must participate more actively in economic management, rather than leaving the full burden of responsibility for overall economic management on the shoulders of governments, as they have tended to do in the past. They themselves will reap the benefits – in the form of a competitive edge on international markets – of greater investment in training, the environment, and the basic elements of infrastructure, such as telecommunications. For their part, workers must agree individually and collectively to learn new skills and to participate through their labour unions in a process of social and economic partnership that will confer greater flexibility on economic development initiatives.

Economic rigidity

There are a number of signs that the Canadian economy is experiencing difficulty in adjusting to the new economic context: high unemployment, longer unemployment spells, and pockets of chronic unemployment.

Canada is clearly having a tough time keeping up with the changing nature of the labour market; one indication is the persistent rise in unemployment since the 1940s, despite strong job creation. The unemployment rate has risen from an average of 4 per cent in the 1950s to 6.7 per cent in the 1970s and 9.3 per cent in the 1980s, although it has stayed under 8 per cent in the past two years.

In June 1990, over one million Canadians – 7.5 per cent of the labour force – were unable to find work. Since then the rate has risen to 8.3 per cent.

The persistence of unemployment in the face of external shocks has never been more evident than in the 1980s. Sooner or later, shifts in the composition of exports and imports, in consumer preferences, and in production technology are reflected in the jobs available to Canadians.

The signs of a failure to adjust smoothly are even more evident when seen from a regional perspective. Whereas in Ontario the unemployment rate averaged 5.5 per cent during the first half of 1990, in the rest of Canada it did not fall below 8.8 per cent. Not only is there a substantial difference between the highest and lowest regional rates, but there has been no decline in these disparities over the past 15 years. Thus, states the Council, we are not facing a short-term difficulty, but a deep-seated, chronic problem.

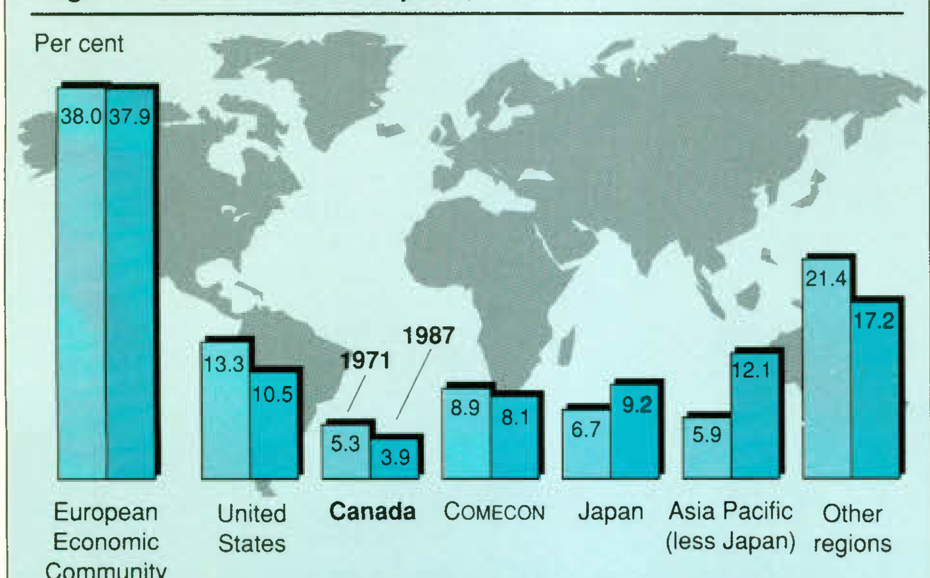
Work done by the Council during the past year throws new light on the importance of economic structure in explaining regional disparities in unemployment rates. For example, structural unemployment declined in Quebec between 1981 and 1986, reflecting a 10-year period of economic renewal; over the same period, it increased in British Columbia, because workers had still not completely adjusted to the modernization of industry triggered by the commodity price shocks and recessionary conditions of the early 1980s.

In Saskatchewan, economic structure accounted for more than half of the unemployment rate disparity with Ontario in 1986. That province (and, to a lesser extent, Alberta and Manitoba) was hit hard by a combination of drought, high interest rates, and falling world grain prices.

In Newfoundland, economic structure accounted for about two thirds of the gap in unemployment rates vis-à-vis Ontario in 1986.

There is no question, says the Council, that the marked differences in economic structure between the regions of Canada make the country more difficult to govern.

Regional Shares of World Exports, 1971 and 1987



However, the majority of workers do make a successful transition between jobs, spending little or no time unemployed. Of successful job finders interviewed in 1986, about one third moved directly from one job to another, with no time spent unemployed; another 30 per cent found a job within four weeks of leaving the previous one. In both cases, successful job changers were most often people who:

- had quit their jobs voluntarily;
- lived in Ontario (with Quebec a close second);
- were males, aged between 25 and 44; and
- changed jobs within the same industry.

Conversely, the least successful job changers were most often those who:

- had been laid off;
- lived in western Canada or the Atlantic provinces;
- were over 45 years of age;
- were women; and
- changed to a new industry.

Other studies have shown that the greatest degree of hardship – unemployment for more than half a year – is concentrated in a relatively small group of people who account for 6 per cent of the labour force. This group, in fact, accounted for 29 per cent of all unemployed individuals in 1986 and for 60 per cent of all the time spent unemployed during that year.

Lessons to be learned

Current unemployment-fighting tactics have tended to focus on income-support programs, which are designed not to eliminate unemployment but to lighten the burden on those it touches directly.

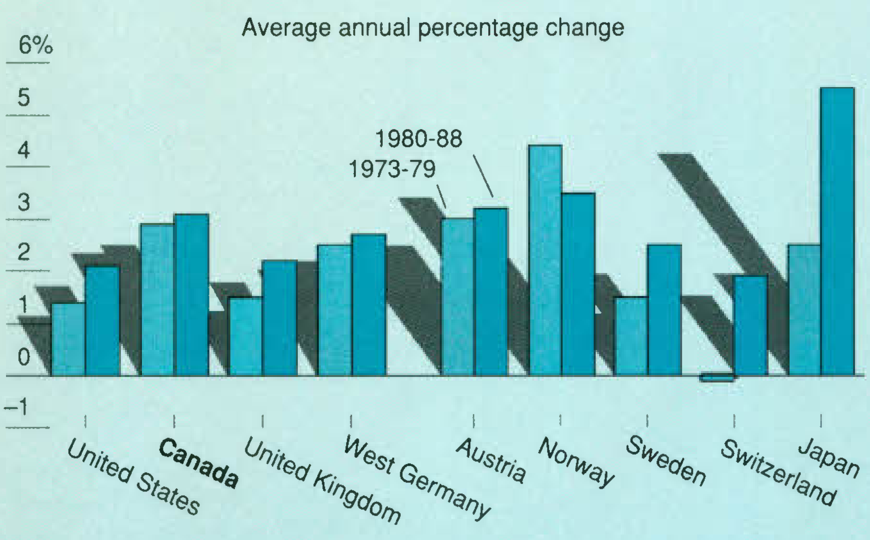
Similarly, the setting of national economic policy is based to this day on the technocratic approaches that developed in the late1940s. What has evolved since then is an approach where governments now rely heavily on restrictive monetary policy to fight inflation while unemployment as national concern has become a poor relation.

Yet certain countries – Austria, Sweden, Norway, and Japan, in particular – have managed for more than 20 years to contain inflation without creating unemployment.

The Council does not advocate borrowing an existing model and applying it outright in Canada. That would be a simplistic approach. Economic policy, like all policy decisions, is influenced by a number of national factors – culture, tradition, and so on. It may be possible, however, to draw some lessons from a comparison of the approaches of these countries to the quest for full employment with the Canadian experience.

The same is true of strategies for fighting unemployment and inflation. Despite the wide differences among the countries mentioned, it is possible to identify some common characteristics that may explain why these countries have had more success in fostering labour force adaptation and achieving full employment.

Real GDP Growth per Capita, Selected Developed Countries, 1973-88



Full employment

The countries that have achieved full employment have made it their primary policy objective. This is true not only of their governments but also of the other social partners involved – labour and business. This significant commitment shapes the attitudes, actions, and behaviour of all the partners.

For governments, employment becomes a prime consideration when decisions are made regarding new economic or legislative initiatives. For labour unions and employers, putting the priority on employment necessitates some changes in behaviour. For example, they must take into account the repercussions of price and salary increases on employment.

However, notes the Council in its 27th Annual Review, it is not enough simply to make full employment a priority. Besides the political will, there must also exist a suitable institutional framework for achieving this goal.

One of the basic common traits in the experiences of these countries is the search for consensus among the social partners to support economic management and the full-employment strategy. For this cooperative process to work, of course, labour and management organizations must exist that are highly structured, centralized, and equipped with the authority to speak on behalf of their members.

Tripartite management has the advantage of letting responsibility devolve to local groups and actors, thereby improving efficiency.

In Canada, the strongest commitment to full employment came with the publication of the White Paper on Employment and Income in 1945, which laid out the economic strategy of the federal government for the postwar era. Even in those times, there was reluctance to speak of full employment; the preferred expression was "high levels" of employment.

In 1975, the fight against inflation became the overriding objective on the political agenda. In the early 1980s, the Canadian government adopted monetary policy so restrictive that the only possible outcome was a recession. The bank rate climbed to 21.2 per cent. The rest of the story is well known: unemployment rose by 4 percentage points within a few months, and the inflation rate fell from 12.5 per cent in 1981 to 5.8 per cent in 1983.

At the moment, there are no participatory mechanisms in the public or private sector for developing general economic policy in Canada. European-style social partnership has simply never taken root here, although some recent Canadian initiatives in that direction have produced some encouraging results. The following are good examples:

– The Canadian Labour Market and Productivity Centre (CLMPC) which provided productive dialogue between authorities responsible for labour market policy and business, labour, and other private sector representatives.
– In Quebec, 12 regional forums and a province-wide forum on employment were held during the summer and fall of 1989.
– In British Columbia, the B.C. Task Force on Education and Training, composed of representatives of labour unions and employer organisations, was mandated in August 1989 to review employment- and training-related issues and submit recommendations to the provincial government.
– In Ontario, the Premier's Council has advised the government to delegate responsibility for training and other labour market programs to an Ontario Training and Adjustment Board, composed primarily of business and labour leaders.

The Council says, finally, that the current rate of unemployment is neither acceptable nor unavoidable. It stresses that alternatives to the current strategy must be explored so that the control of inflation and the pursuit of full employment figure side by side as top economic priorities of government in Canada.

Performance targets

To examine what possibilities exist for pulling Canada out of its present dilemma, the Review looks at the trade-offs between different policy strategies by asking a number of "what if" questions. Using an econometric model, researchers assessed the way in which certain policy choices would affect the economy over the next five years.

The questions posed were:
– What would be the consequences of a sharp spike in interest rates if the strength of demand led Canadian monetary authorities to take a more cautious approach towards inflation pressures?
– What would a sharp recession mean for Canada during the current period of adjustment?
– What would be the implications of reaching an interim target of 3 per cent for inflation if wages and prices were more flexible?
– How much has the fiscal action of recent federal budgets actually contributed to deficit reduction?
– What would be the impact of an easier monetary policy?

Damage to the economy, in this year's base case projections of the Review, are controlled by a moderation in monetary policy combined with a more favourable international environment.

Even this scenario, which is the best that can be hoped for under current circumstances, produces, according to the Council, results that fall well short of the desirable targets.

The situation is not entirely gloomy in the base case. Growth in productivity, employment, and output is close to the target ranges for the period 1992-95, when the economy returns to more normal growth rates.

What is unsettling, however, is that there is a serious possibility that even this relatively unsatisfactory performance cannot be achieved. Conditions in the world economy – rising interest rates and uncertain oil prices, plus the risk of a recession in the United States – raise the probability of a serious setback in economic growth.

When we attempt to sketch out policy options here in Canada, we encounter a logjam that cannot be broken, concludes the Council, without a change in expectations and attitudes.

The Canadian economy depends strongly on export markets.

Regional economic structures and labour markets

A search for new options

The search for solutions to improve Canada's ability to react appropriately to the structural changes of the 1990s and the development of a policy and institutional framework to replace our current strategy must focus on regional economic structures and the operation of the labour market.

To reduce unemployment, ways must be found to improve the capacity of Canadians to adapt to the dramatic changes taking place in the world economy, as stated previously.

In its analysis of the economic challenges facing Canadians over the next several years, the Economic Council states that its objective is not to propose a comprehensive blueprint, but to identify a range of options and point out the inherent obstacles.

Four ingredients are necessary to improve the adjustment capacity of the economy:

- active labour market programs;
- a change in mindset on the part of workers, business, communities, and governments;
- a partnership among the socio-economic players that delegates the responsibility for labour market programs to labour, business, and other economic agents; and
- a set of monetary and fiscal policies that work together to create a healthier economic environment.

Stronger regional economies

Strengthening the economic base of high-unemployment regions must remain a central objective of Canadian economic policy. Thus the Council supports the federal government's current strategy to promote diversification of the regional industrial base. Much more must be done, however, before these efforts at diversification can be termed a clear success.

One obvious priority is to ensure that the appropriate technological infrastructure is in place to enable individuals and firms in the regions to communicate with customers and suppliers in all parts of the world. Another is to make sure that workers are properly trained to use these technologies, no matter what industry they work in. Human capital in technology-driven activities is increasingly becoming a decisive factor in economic performance. Provinces must do their share by investing in upgrading their education systems and training and retraining programs.

Another priority is dismantling the barriers to innovation in the regions, i.e., obstacles that impede or prevent the start-up of new businesses. For example, unemployed workers who chose to start their own business were, until very recently, ineligible for unemployment insurance benefits. Studies in France and the United Kingdom have shown that between 50 and 60 per cent of participants in such schemes remain in business longer than three years.

Echoing a recently published Statement, the Council also questions the effectiveness of ad hoc, bureaucracy-driven plans for regional development. Such top-down programs have fallen into disrepute. Policymakers are now paying more attention to the harnessing of local talents, expertise, and resources. The aim is to enable citizens to take charge of the economic well-being of their own communities.

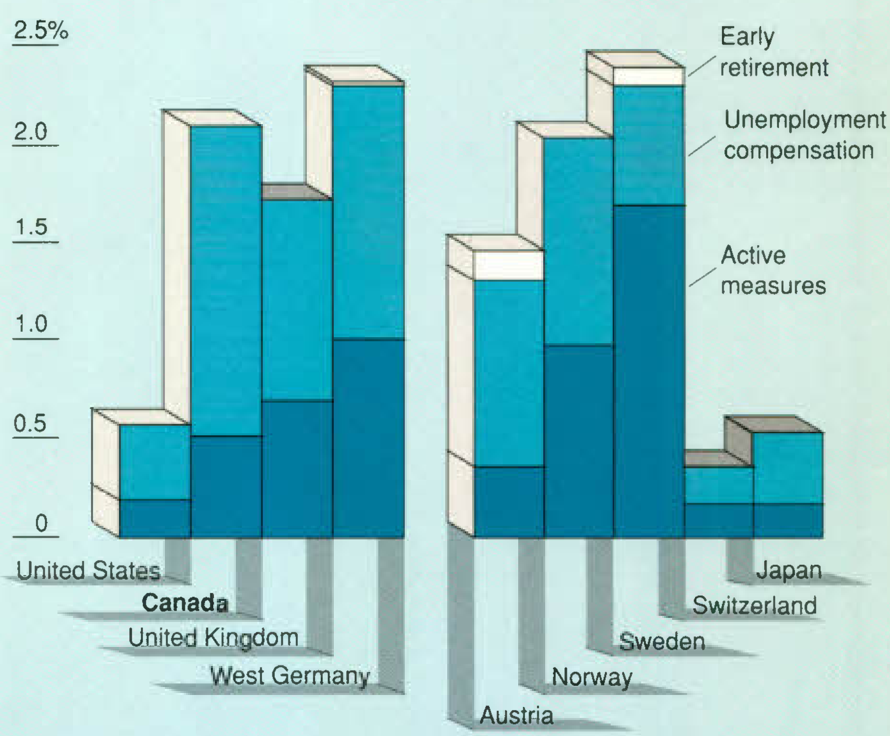
Labour market policies

The key to adjusting efficiently to new trends in the world economy and to guarding against unforeseen shocks still lies with a labour force that is flexible, mobile, and ready to adjust to new jobs and to acquire new knowledge and skills.

A new policy for the labour market, therefore, should include the following elements:

- a move from income support towards more-active labour market policies;
- special attention to the employability of disadvantaged groups;
- more input from labour and business and from local communities in the design and delivery of labour market programs; and
- the adoption of workplace practices aimed at fostering internal adjustment.

Public Expenditures on Labour Market Programs, Selected Developed Countries, 1989



While passive income support is a necessary element of the social safety net, the Council believes that it must be combined with active measures that help workers to adapt to a changing world. Some recent initiatives seek to widen the conditions under which unemployment insurance (UI) recipients would be eligible for training. Canadians have not yet transformed UI into a truly active labour market program, however. Much more remains to be done.

Workers must also come to appreciate the importance of acquiring new skills and maintaining an open mind about new careers. Parents and communities must, among other things, discourage young people from believing that being fishermen or farmers, generation after generation, is their preordained destiny – one that the state must accept without challenge.

Canadian firms must give a much higher priority to worker training. Currently, they are spending approximately $1.4 billion on training. On a per capita basis, this represents less than half of what U.S. corporations spend.

Flexibility in the workplace

The way in which labour is reallocated within firms in response to foreign competition is of great importance for the process of adjustment.

One important way to encourage greater efficiency and competitiveness is through new approaches to work organization, labour relations, decision-making structures, and management style.

Innovations of this kind over the past few years have often met with scepticism from workers and unions, since in some cases they were an ill-disguised attempt to keep the company or plant union-free. Successful innovation depends on a determined effort to build channels of communication that promote mutual trust within the firm.

One innovation that has gained attention is the shift from fixed wages to contingent-payment schemes whereby employees' wages are linked to the firm's profits, the work unit's productivity, or a worker's skill attainment. The Council recognizes that these plans have not proven popular in Canada. In fact, broad diffusion of contingent-pay practices is unlikely to occur unless they are accompanied by changes in management practices aimed at gaining and sustaining workers' trust. These systems require, notably, the sharing of more information on current financial performance and future business plans.

Work organization and practices represent another prime area for innovation aimed at overcoming the inefficiencies associated with rigid and narrow job classification. However, workers have traditionally viewed the rigid delineation of jobs as a necessary condition for the proper operation of the seniority system, which is now the primary determinant of wages and employment security in most firms. Alternatives to the seniority system will have to be found in order to provide the employment security sought by workers without handicapping firms with rigid job classification systems.

In short, partnership may have its biggest role to play at the firm level.

Social partnership

The development of social consensus and the adoption of guidelines of a voluntary incomes policy should perhaps be a key component of anti-inflation strategy.

Tripartite systems based on central bargaining and compromise among the social partners – business, labour, and government – over a wide range of economic policy issues seem to offer the best hope for controlling inflation without creating an unacceptable level of unemployment. Although the schemes used in other countries differ in important ways, they all rely on a form of voluntary incomes policy.

The tripartism needed to implement such a policy simply does not exist in Canada, where Canada's economic and political institutions are characterized by fragmentation. Power is shared among various levels of government, and there is no single organization that can speak for labour organizations.

That is not to imply that partnership is a dead issue in Canada, says the Council. Partnership can play an important part in improving Canada's capacity to adjust to the new realities.

But a voluntary incomes policy can only be successfully introduced, concludes the Council, once new relationships have been forged and social partnership becomes an accepted institution in the country.

A coordinated approach by all Canadians will be necessary to confront the transitions of the 1990s.

A new economic policy framework

If there is one lesson to be learned from the economic policies of the 1980s, it is that fighting inflation through the exclusive use of monetary policy is very costly. Thus the efforts of the central bank should be supported by governments, business, and labour.

In its 27th Annual Review, the Economic Council proposes a long-run objective of improving the efficiency of markets to allow unemployment rates to drop below 7 to 8 per cent before inflation pressures begin to emerge.

It will not be easy to achieve this goal. As already discussed, fighting inflation effectively will require both revamped weapons and specific targets that are coordinated and credible. It hardly need be added that Canada's diverse nature and sheer size complicates action in this regard. The wide variation between regional economies across the country means that a national policy that improves the situation in one region often creates new problems elsewhere.

This fact casts serious doubt on the wisdom of relying too heavily on restrictive monetary policy to fight inflation. A recent example: when the federal government tightened monetary conditions in an attempt to counteract overheating in the Ontario economy, one unfortunate consequence was to aggravate problems in the West, still recovering from the effects of the recession.

Statements by the Governor of the Bank of Canada and the Minister of Finance help to shape the behaviour of business executives who exercise some control over the determination of wages and prices. But their statements are unlikely to influence the expectations of the general public or to have any direct influence on workers' wage demands. For the majority of Canadians, expectations about inflation are based more on everyday experience than on official pronouncements.

The Council also singles out for disapproval the lack of consistency between the actions of governments at all levels and the statements made by the Governor of the Bank of Canada. Many public officials do not take stock of the impact of their decisions on the rate of inflation. "They do not realize," states the Council, "that they are undermining the credibility of the stated objectives of the monetary authorities by creating a state of confusion in the public's mind that tends to entrench inflationary expectations and, in turn, to make monetary policy more restrictive than it need be."

New institutional arrangements

New institutional arrangements will be essential during the period when the main focus of the federal government's fiscal policy will be deficit reduction. In the longer term, these ideas may well provide the foundation for a new approach to the formulation of economic policy in Canada. The key elements of these new arrangements are:

- a credible approach to inflation targets;
- a coordinated inflation target;
- a coordinated fiscal policy;
- more responsive wages; and
- a framework for social partnership.

The Council believes that controlling inflation is a policy objective that benefits Canadians in all walks of life. This is especially true for those on fixed incomes or with limited bargaining power, as well as for firms and workers who must compete in international markets.

This implies that *all* Canadians should strive to avoid placing unnecessary pressure on prices and costs.

These observations lead the Council to two main conclusions about anti-inflation policies:

- the Bank of Canada's objectives must be both clearly defined and perceived as feasible in the medium term; and
- all levels of government and all public authorities must assume greater responsibility for controlling inflation.

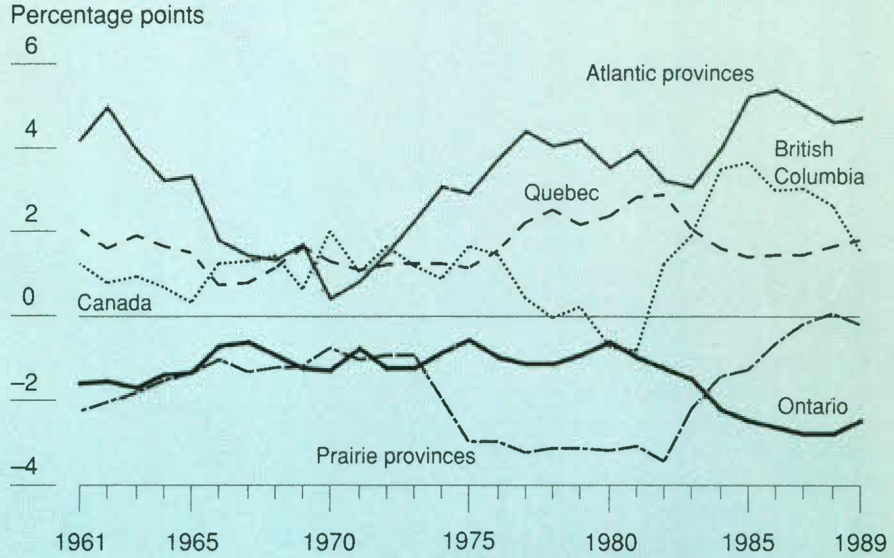
Meetings of federal and provincial finance ministers, or possibly First Ministers themselves, would be the appropriate forum for working out the guidelines for public-sector decisions on government charges (taxes, prices, user fees) and regulations.

At the same time, each provincial legislature should establish a standing committee with a mandate to review any decisions within its jurisdiction that appear to exceed the guidelines established at the ministerial level.

While, naturally, there are some risks involved in this approach, it offers the distinct advantage of ensuring that government decisions "lean" in the same direction as monetary policy.

The Council also argues that, if prices and wages would react more quickly to

Difference between Provincial/Regional and National Unemployment Rates, Canada, 1961-89



tighter monetary conditions, it would not be necessary to depress production and employment for such long periods. During the last recession, for example, wage increases did not begin to decline until 18 months after unemployment had begun to rise.

Part of the blame for this inertia rests with the collective-bargaining process. Collective agreements often cover two- to three-year periods. Only a small number of wage contracts are negotiated in any given year, and they take into account the economic conditions prevailing at the time.

Shorter contracts and synchronized collective bargaining, even within a system of decentralized collective bargaining, would help to reduce the rigidity of wages and prices and to increase employment stability.

Recognizing that this system would present its own inherent problems, the Council suggests a possible compromise solution: keeping long-term contracts for nonwage benefits, with a provision for yearly negotiations on wages only.

The Council also points to gain-sharing plans as a way to increase employment stability.

Lastly, coordinated fiscal policy can play an important role in the fight against inflation. "Why slow down the country as a whole when the source of the inflation is localized?"

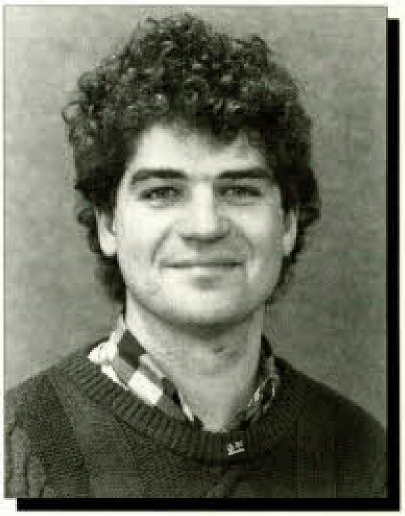
An important step in this direction would be to encourage provincial governments to assume greater responsibility for the fight against inflation through their own fiscal policies. Policy coordination could also extend to municipalities, whose budgetary envelopes will continue to grow in response to the rising demand for services on the part of their residents.

Unless greater maturity is instilled into federal/provincial relations, concludes the Council, it is difficult to be optimistic about Canada's ability to cope with the transitions ahead. The costs of a lack of policy coordination, as documented in the Review, must convince governments to rise above their present divisions. If they do not, Canada's options will be limited and unappealing.

A collective effort to control inflation and to fight unemployment would put the Canadian economy on a healthy growth path for the medium term and would also help Canadian society through a vital transition to a policy framework suited to the realities of the 1990s.

New Council members

Ken Woods is the International Vice-President for Canada of the International Brotherhood of Electrical Workers. Born in Guelph, Ontario, he has held, since the early 1960s, numerous positions in the labour movement. He sits as a member of the Construction Industry Advisory Board of Ontario, the Canadian Executive Board – Building and Construction Trades (AFL-CIO) and the Executive Board of the Canadian Federation of Labour (CFL).



Pierre Paquette is Secretary General of the Confederation of National Trades Union (CNTU). He holds a master degree in economy from the University of Montréal and has completed studies at the doctoral level at McGill University. He was President of the Conseil central de Montréal of the CNTU. He also taught economy at Maisonneuve College, he was lecturer at McGill University from 1984 to 1985, and has been at the University of Montréal since 1988.

Two steps forward

How well the Canadian economy will fare in the era of high technology depends critically on our capacity to "work smarter."

Working smarter demands two things: a capacity to innovate in our technological infrastructure and, at the same time, a willingness to invest with the same degree of creativity and vigour (if not more) in human-resource development.

These twin goals are the "two steps forward" that all Canadians – workers, businesses, labour unions, and governments – must take if they are to have any hope of meeting the challenges of increasingly stiff competition on national and world markets, both today and tomorrow.

In a publication appropriately titled *Two Steps Forward*, two research directors at the Economic Council of Canada, Gordon Betcherman and Keith Newton, joined forces with writer Joanne Godin to illustrate from a series of case studies how a powerful synergy can develop between a well-prepared work force and the latest technology, a synergy that can allow Canadian firms to go head-to-head with their competitors.

The researchers begin by noting that global economic and technological realities have changed dramatically. While pure technological advantage is certainly important, it is a fleeting, transitory phenomenon.

Human resources

Access to technological innovation, therefore, must be complemented by a management style that is sensitive to the role of human resources and the need for professional development. This new emphasis on human resources should not simply be a reactive strategy to offset some of the costs of progress. It must explicitly embrace a range of policies and practices designed to enhance the skills, adaptability, motivation, and performance of workers.

By equipping workers to cope with adjustment to change, this approach minimizes both personal and organizational costs and, in addition, ensures the fullest exploitation of the potential of new technologies.

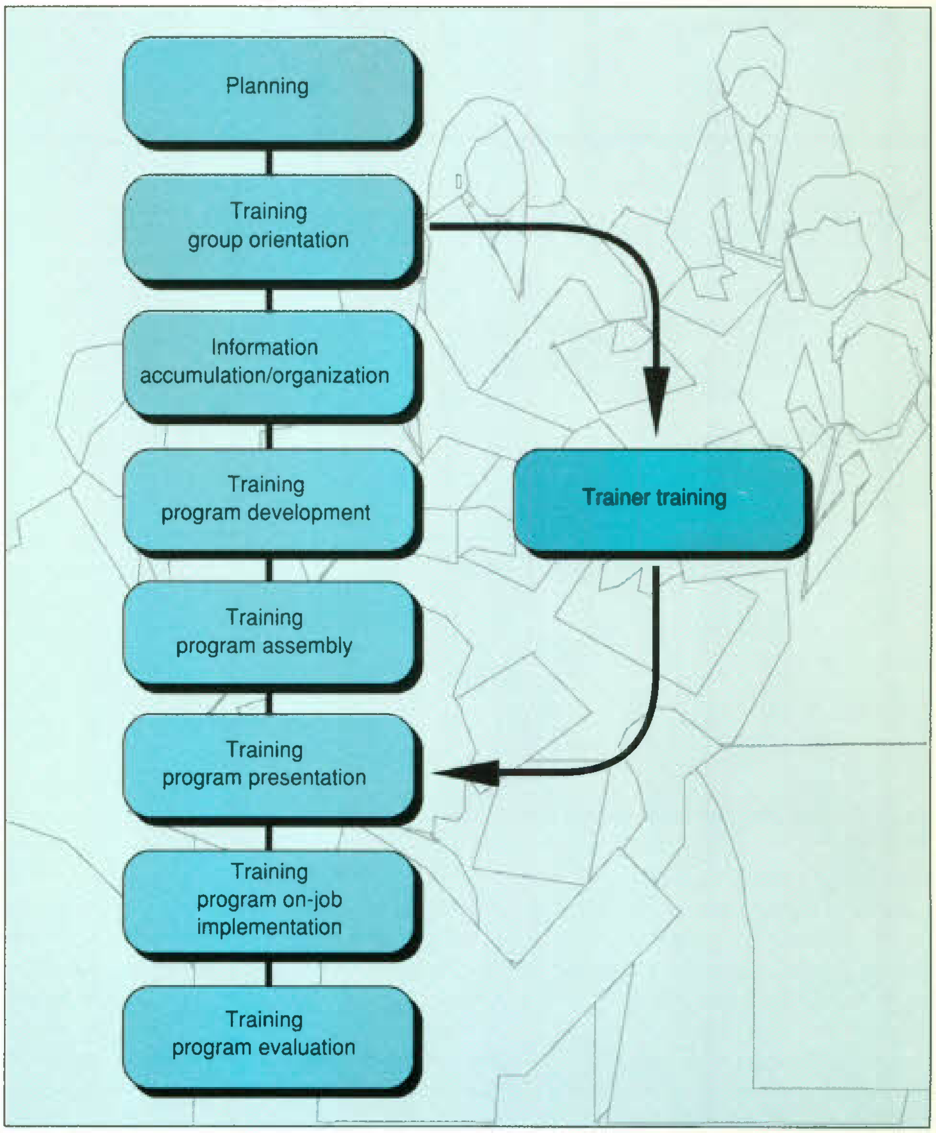
Because of demographic developments, the pursuit of this "innovation synergy" will prove to be even more important in the coming years. As the population ages and the labour force grows more and more slowly, Canadians will be increasingly forced to seek innovative ways to realize the potential of their human capital.

The Canadian experience in this area is somewhat contradictory. It gives cause for both optimism and concern. The case studies conducted indicate that Canadians *can* exercise the foresight, judgment, and good will needed to successfully exploit new technologies in innovative work settings manned by a well-motivated and highly skilled work force. At the same time, it is equally apparent that the processes of technological and organizational innovation, as well as human-resource development, constitute a complex and continuing challenge. "Change is uneven, disruptive, costly, but nonetheless, unceasing," state the authors. "People and organizations, no less than machinery and equipment, need constant care and upgrading."

No miracle cure

The work of the researchers left it clear that there is no miracle cure. While they succeeded in identifying some key ingredients to success and some guiding principles, they stress that they found no ready-made blueprints or instant answers.

People and organizations are unique. They do not come with a detailed set of instructions for installation and servicing. Given the human dimension of the



innovation process, there is rarely a predetermined recipe for success.

The authors find it regrettable that in too many enterprises there is still a relatively greater emphasis on the husbanding of financial and physical resources than on human and institutional resources.

While there are many fine examples of Canadian successes with an integrated approach to the management of workplace innovation, the authors found no firm that was exemplary in itself.

In some enterprises, innovation design was purely technical, with no attention paid to implications for job content. In certain cases, workers found out about technological change only when new equipment arrived at the plant door. The authors note instances where joint decision making really involved management telling the workers what it intended to do. In other cases, fundamental disagreements between the parties could not be resolved. Finally, some firms simply excluded labour unions from the planning process for high-tech production as a matter of policy.

Some objectives

Those case studies where firms enjoyed at least some success point to a number of promising approaches that organizations would do well to observe, say the authors. They mention the following as objectives:

- planning both the technical and social aspects of change in advance;
- developing job designs that incorporate human discretion, responsibility, and skill;
- retraining existing employees so they can be part of the future;
- adapting technologies to expand opportunities for the disabled;
- sharing the added prosperity brought about by technological change; and
- committing themselves to the concept of "involvement" in which all stakeholders have the opportunity to influence the innovation process.

The authors realize that, in many respects, approaches such as these run counter to traditional ways of doing things in Canadian industry.

The importance of communications

Communication plays a critical role in implementing technological and organizational change in the workplace.

Open communication between workers, their unions, and management, and among all levels of an organization can help avoid technological pitfalls and lead to enhanced productivity and job enrichment. According to the authors, a strong union and a strong management team both benefit when common goals are agreed upon and problems are dealt with openly.

In the end, there is a significant degree of complementarity between workers' needs and management goals. "All can win," state the authors.

Employee participation is essential, they believe, to the design of work systems that "fit," and to the goal of increasing workers' accountability and independence in their jobs.

The cases show that virtually all workers can be trained and retrained in the new skills demanded by technological change. High-tech jobs can be made more challenging and interesting for employees, and can sometimes result in better-paying, higher-status positions.

The "socio-technical" approach to organizational design, which aims at planning a work environment that gets the best out of new, integrated computer systems and a new work force, demands careful planning and extensive consultation with employees.

The popular image of the high-tech sector may be inaccurate. The reality is that this industry runs on its people. "Human skills – creativity and knowledge – are behind all the frontier hardware and software, so high-tech firms face a powerful human-resource imperative."

The challenge is all the greater because the sector is intrinsically an unstable one. Products have a very short life cycle, firms come and go, and risk-taking never stops.

In the end, conclude the researchers, Canadian industry faces a choice about how it will operate in the emerging high-technology world. It can pursue the traditional logic of automation – essentially, the mechanical substitution of technology for people – without considering organizational or social implications. Or it can adopt a broader view of new technology in order to invite workers into the process of technological innovation.

We must learn to rely as much on human resources as on new technology.

The deficit virus

Council Chairman, Judith Maxwell, spoke recently on the effect of the deficit on the Canadian economy to the members of the Edmonton Chamber of Commerce. Following is an abbreviated version of that speech.

This is a troubling time for Canadians. We face a period when Confederation must be rethought against a backdrop of regional tension and unprecedented pressures from our aboriginal peoples. The outbreak of hostility in the Middle East creates uncertainty about world military and energy security. Doubts are being expressed about Canada's ability to remain competitive in an increasingly aggressive global marketplace. And, last but by no means least, we may be teetering on the brink of recession. Against this broad canvas, we must discuss the federal debt and deficit.

In my view, the deficit is a bit like a computer virus. Once a part of Canadian society, the effects of the deficit proliferate exponentially, impinging one way or another on nearly all of the issues I mentioned a moment ago.

The nature of the problem

The basic problem is that governments in Canada are spending more than they raise through taxation. The federal government in particular is borrowing to pay interest on the public debt, and, in the process, is pre-empting savings that would otherwise be financing investments that would generate income for future generations of Canadians. In the process, we have become more dependent than ever on borrowing from abroad. And we have left too much of the burden for controlling inflation to tight money.

Note that there has already been a considerable retrenchment in the federal finances. Ottawa has been running an operating surplus since 1985, meaning that total revenues have been more than enough to pay for program commitments. It is the interest on the stock of debt outstanding that accounts for this year's deficit of roughly $25 billion (on a national accounts basis). In short, Ottawa is borrowing to pay interest on its debt. I used to say that we were borrowing to buy the groceries. Now, it is fair to say that we are borrowing to pay the interest on the bill for last year's groceries. This is the virus that plagues us.

In my view, the virus is deeply rooted, politically and economically. Canadians want their federal government to provide a vast array of services – transfers to individuals and provinces, subsidies for agricultural support, transportation systems and energy projects, cultural preservation, training, justice and public security, and so on. At the same time, however, Canadians are sending clear signals that they do not want to pay higher taxes and, in some cases, they are fed up with current tax levels.

There may be a majority of Canadians who wish to reduce the deficit, but there is no clear majority in favour of any of the traditional options of cutting spending or raising taxes.

In fact, the spending cuts outlined in recent budgets have probably aggravated political tension in this country. The whole tenor of relations with the provinces has changed, for example. Cutbacks in transfer payments have drawn bitter criticism from many provincial ministers, who believe their province does not get its fair share of federal largesse. Also, scaling down federal projects has actually left some communities feeling betrayed by their national government.

There is in fact a large gap between what citizens want and what they are prepared to pay for. That is the political dimension of the virus. The economic dimension is just as intractable. Efforts to reduce the deficit have been especially handicapped by high interest rates.

The obstacles

The level of "real" interest rates, on average, has been far higher through the 1980s than in either of the two previous decades. "Real" rates in Canada in the first half of 1990 averaged about 10 per cent. This is exceptionally high by historical standards – the average was very low in the 1970s and was about 6 per cent in the 1980s.

Our sense at the Economic Council of Canada is that we should anticipate relatively high real interest rates to continue through the 1990s. This is predicated on central banks' continued determination to resist inflation, the strong capital needs connected with Europe 1992 and the reforms in Eastern Europe and the Soviet Union, not to mention requirements in other parts of the world, including the developing countries.

Judith Maxwell

You will recall that last February's federal budget anticipated a decline in interest rates that would begin this year and gain momentum in 1991. Reading between the lines, it appears that the underlying view was that real interest rates in the next few years would average 3.5 per cent compared to the 6 per cent that prevailed through the 1980s. In our projections at the Council, we are looking for real rates to fluctuate in the 5-per-cent range in the next few years. We expect nominal short-term interest rates to continue the decline that began last spring and to reach the 10-per-cent range by 1992. Then as inflation decelerates, interest rates will fall further. While this is definitely an improvement on the environment we have faced in the past year, it is an interest rate scenario which will make deficit reduction exceedingly difficult over the next few years.

The progress to date

The payoff from the restraint embodied in the April 1989 and February 1990 budgets shows up in two ways. First, the federal government's fiscal position is improved, as you would expect – the debt-to-GDP ratio is expected to decline significantly by 1995 if a scenario of recession can be avoided. One key reason for the improvement is that the annual cost of servicing the public debt falls by $10 billion. This reflects two forces. First, there is a slower accumulation of debt, and, second, interest rates are about half a percentage point lower because the government is borrowing and spending less.

The other payoff is that overall economic performance is improved in the long term. Because interest rates and inflation are lower than in the absence of restraint, investment and productivity should be higher. And this builds the foundation for higher real incomes of Canadians in the longer term. This is true despite the fact that restraint slows the economy in the first year or so, so that output and employment are slightly lower in the period 1990-95 than they would have been in the absence of the restraint in these two budgets.

This analysis illustrates the complex feedback effects in the economy, notably the interaction between monetary and fiscal policies. Many of the positive effects occur because restraint reduces the burden on monetary policy by slowing spending. This in turn creates a more favourable financial environment for investment. In other words, deficit reduction is favourable to a sustained decline in interest rates.

But this interaction is a two-edged sword. It cuts both ways. A severe recession would seriously undermine the fiscal plan, eliminating nearly all the progress that was made in the past two budgets. It would create the environment for a proliferation of the deficit virus and would put the federal government in the terrible dilemma of having to raise taxes or cut spending in the middle of a recession.

In summary, Ottawa is under pressure from all directions. The incipient tax revolt restricts the government's scope for action on the revenue side. Spending cuts in specific areas tend to put more political stress on the social fabric of the country.

But, without deficit reduction, this backlog of debt will erode the capacity of the government to deliver the basic services that people want and need. In short, we have to retrench in order to make progress on reducing the debt burden. The reward at the end of the process is that, once the debt-to-GDP ratio does start to decline, we enter a virtuous circle where interest rates in Canada can drop to levels closer to historical norms. This, in turn, speeds up the progress in getting the federal finances in order.

When faced with excessive debt, the private sector has options that are somewhat more clear-cut than those available to government. Companies can sell off assets, they can reorganize so as to curtail their less profitable operations, or they can go out of business.

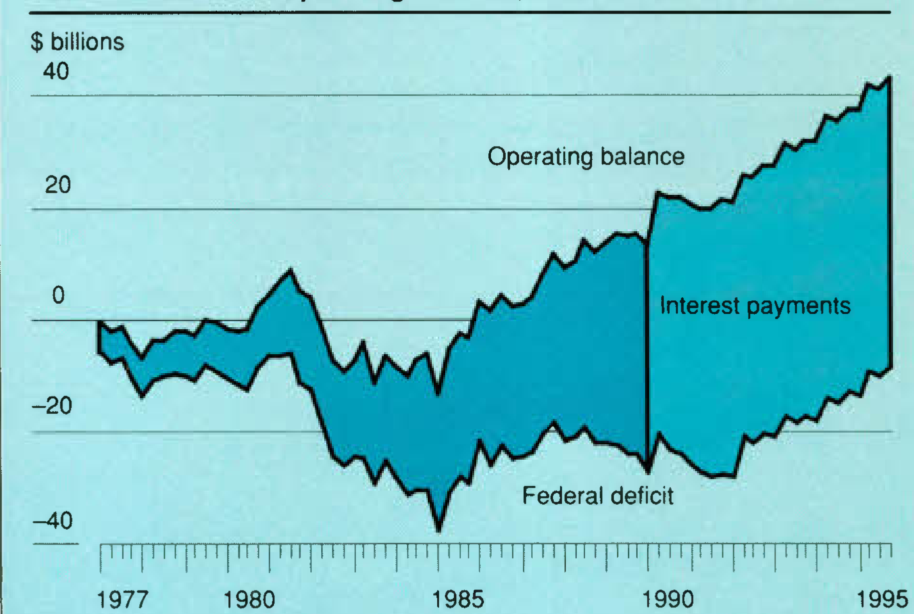
The federal government has sold off some assets, and it has done some reorganization. But it is not in a position, in these troubled times, to undertake drastic and unilateral fiscal surgery. Any changes to major programs such as transfers to provinces or to individuals will require a lot of analysis as well as careful consultations with all of the parties involved. In effect, we are talking about a redefinition of what citizens want most in the way of public services, and how much they are willing to pay for those services.

In the Council's view, Canada has reached a stage where we need to find new ways of making decisions on economic policy issues. The Council has been developing some options, which should help governments to cope more effectively with this deficit virus while making progress on other important economic goals like employment and inflation.

In closing, let me say that there are no quick and easy solutions to the deficit problem. Some progress has been made, but a recession could wipe that out and cause the deficit virus to flare up again. Nor do I think that we can expect declining interest rates to be enough to solve the problem for us.

Yet, for the sake of future generations, we have to make a determined effort to climb over this mountain of debt. It seems inevitable that the federal government will be forced to curb existing commitments even further just to meet the new claims on the public purse in the next few years. This will be tough medicine to take, but we must bear in mind that it will eventually bring genuine longer-term payoffs for all Canadians.

Federal Deficit and Operating Balance, 1977-95



PUBLICATIONS

Twenty-Seventh Annual Review

Transitions for the 90s – Twenty-Seventh Annual Review (EC21-1/1990E; $11.95 in Canada; US$14.35 outside Canada).

This year's Annual Review presents a medium-term outlook which falls short of what the Economic Council of Canada considers a desirable performance with respect to inflation, unemployment, and the federal fiscal position. The Review identifies the rigidities in labour markets and the problem of regional economic specialization as two key factors that explain the high level of structural unemployment in Canada.

The Council identifies two transitions that must be made for the 1990s: gearing up for new global realities, which will inevitably cause major changes in the composition of employment, and development of a new set of institutional relationships which will enable Canadians to control inflation with less pain.

Annual Report

The Economic Council's *Annual Report* for 1989-90 is now available. It includes a message from Chairman Judith Maxwell, as well as details on Council activities and research projects. One article describes the research process at the Council. For a free copy, write to the Publications Division (address below).

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