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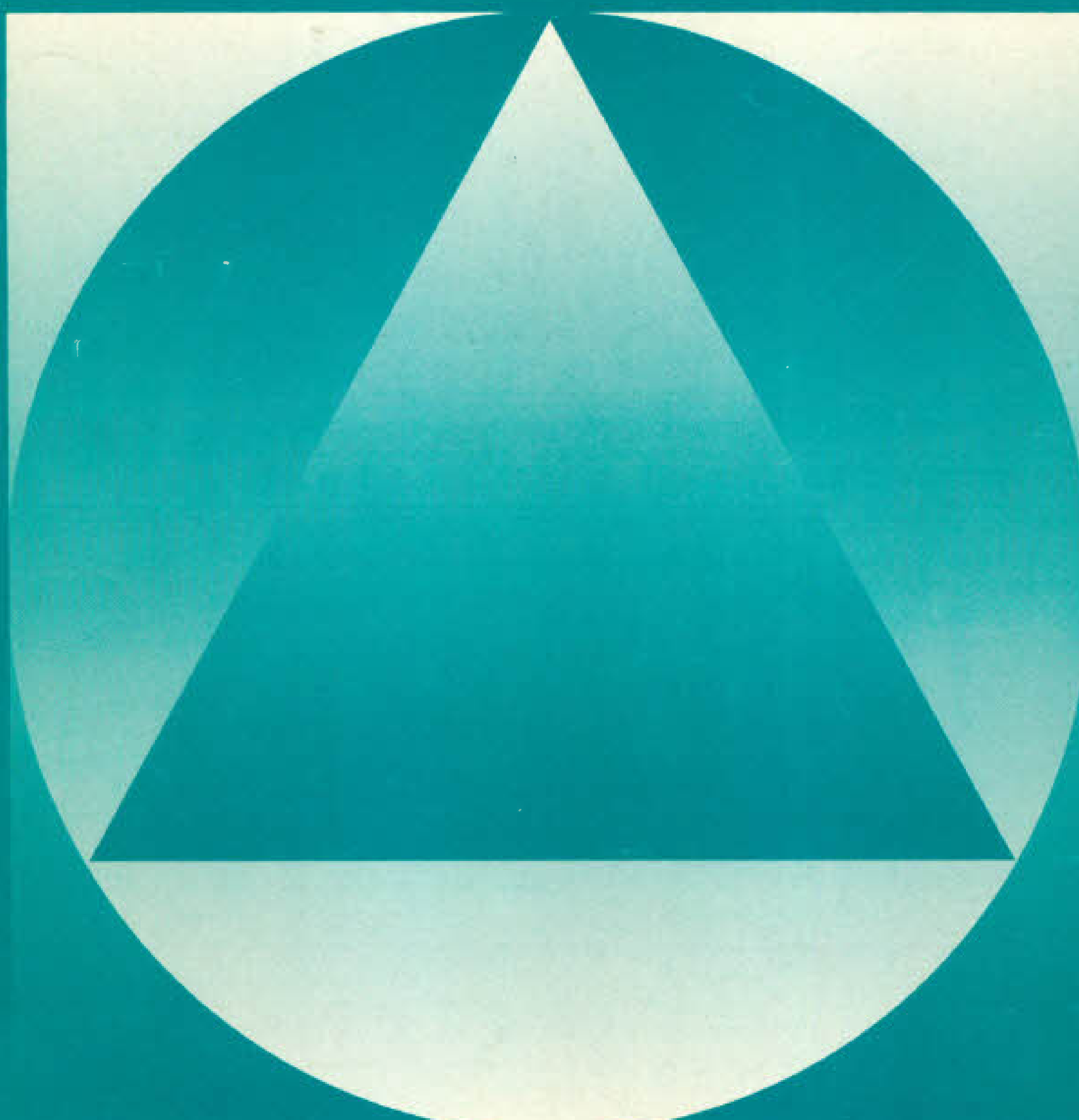
Economic Council of Canada
Volume 9, No. 2, 1988

The Council's Annual Review of the economy



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PUBLICATIONS

Twenty-Fifth Annual Review

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The Twenty-Fifth Annual Review sets out Canada's medium-term economic prospects against a backdrop of such long-run trends as the global stagnation of commodity prices, the growing fragmentation of world economic power, and the shift from a resource-based to a service economy. The Council presents a new set of targets for economic performance for the next five years, mindful of the fact that, after six years of strong growth, the economy is now entering a danger zone in which accelerating inflation and recession could both occur. The Review also focuses on the growing disparities in regional unemployment rates, resulting in part from differences between the regions in the way that the industrial structure is changing. These structural shifts are altering the nature of work and causing a mismatching of people and jobs. The Review proposes two priorities for economic policy: enhancing competitiveness; and strengthening human resources.

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FEATURE

Back to Basics

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ISSN-0226-224X

CAN EC22-70/9-2

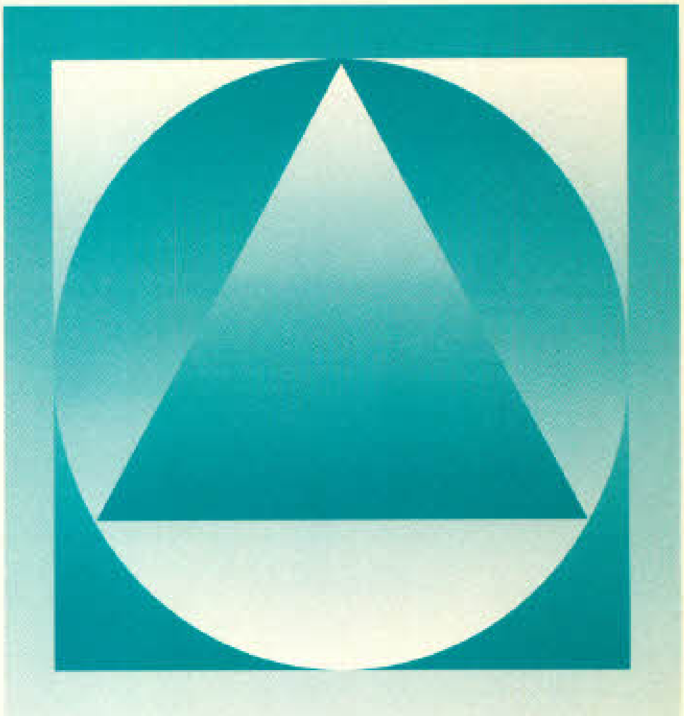
FEATURE

Back to Basics

Over the next five years, Canada needs to show more fiscal restraint, enhance its competitiveness, and give greater priority to developing its human resources, the Economic Council says in its Twenty-Fifth Annual Review of the economy.

Attention to these three priorities is crucial in order for Canada to prosper in an increasingly complex world marketplace. Without strong fiscal restraint by governments, significant economic hardship may be inflicted on the economy in general and on regions outside central Canada in particular, the Council warns. To increase its competitiveness, Canada should, among other things, continue to pursue more open trade with other countries, develop and use more technology, and improve its education system. All players in the economy must work to improve the quality and adaptability of the labour force, which will be so important to productivity growth and competitiveness in the years ahead. These three priorities will remain important, not only in the medium term, the Council maintains, but well into the next century.

The Council looks ahead in this year's Annual Review to the year 2000. It also takes stock of Canada's economic performance over the past 25 years.



Looking back

On looking back, Canada has much to be proud of, the Council says. Today, Canada is a more productive nation. More Canadians, including many more women, are in the labour force. Output per worker is nearly half again as high as it was 25 years ago, and partly as a result, Canada is a richer nation: real income per capita has more than doubled since 1963.

For most Canadians, the quality of life has also improved in many respects. They enjoy a rich cultural life, and people generally are healthier and have access to a wider range of educational programs and institutions.

But there have been setbacks. Several recessions have interrupted economic growth, the worst of them occurring in 1981-82. Since the mid-1960s, unemployment has persistently trended upward, and it remains unacceptably high in many parts of the country. Real wages for some workers have been declining for more than a decade, and many Canadians still live in poverty. Governments are burdened by excessive debt loads. Environmental degradation has become a major concern.

Reasons for caution

Since 1982, Canada has made some progress in restoring productivity growth, competitiveness, and price stability. But Canadians will have to be cautious over the next few years for at least two reasons. First, any sustained period of growth, such as that which has occurred since 1982, tends to lead to imbalances in financial markets and to bottlenecks in production. This raises two threats: that of either a recession or a burst of inflation. Second, storm clouds remain on the international horizon – notably the problems stemming from the huge U.S. trade and budget deficits, and the faltering economies of many heavily indebted developing countries.

Over the longer term, the Council identifies three trends in particular that will continue to have a bearing on future progress. First, commodity prices in relation to the price of manufactured goods are generally unlikely to boom over the next few years. While this is a source of some economic stability for the world economy, countries or regions (like western Canada) will find their economic growth constrained. Second, the shift in the industrial structure from goods-producing to service industries demands new skills in the work force. Third, the fragmentation of economic power, as the United States loses its dominant leadership role, adds to economic uncertainty and complicates international decision making.

The research

With these trends in mind, the Council undertakes a detailed examination of Canada's medium-term prospects. It highlights some of the tough trade-offs between policy objectives, with special emphasis on the tensions between unemployment and inflation. In particular, it examines why high unemployment persists in some regions of Canada. Drawing on its research project "Visions of Canada in the Year 2000," the Council also looks at the long-run trends in global politics, economics, population, ecology, and technology. Finally, the Council sets out priorities for economic policy and new targets for Canada's medium-term performance. *Au Courant* summarizes this research on the following pages.

Outlook for the economy

The charts on the next two pages indicate the outlook for six key economic indicators over the 1988-92 period. In each case, the basic projection is compared with three alternatives – a high-growth, a low-growth and a policy-mix case – based on different assumptions about international developments and the strength of consumer and business confidence in Canada.

Growth

According to this year's base case, real economic growth in Canada over the 1988-92 period is projected to average 3 per cent annually. In 1988 it is expected to reach 3.8 per cent. But a combination of slower growth in exports to the United States and a tail-off in the domestic investment cycle, particularly in the housing sector, will depress annual growth rates to the 2.2 to 2.6 per cent range in 1989 and 1990.

The deficit

During the 1988-92 period, the federal deficit as a proportion of gross domestic product (GDP) is expected to average about 4 per cent. Because of the slow growth in 1989-90, however, the Council sees little likelihood of a quick improvement in the federal deficit, despite assuming a continuation of rigorous spending restraint.

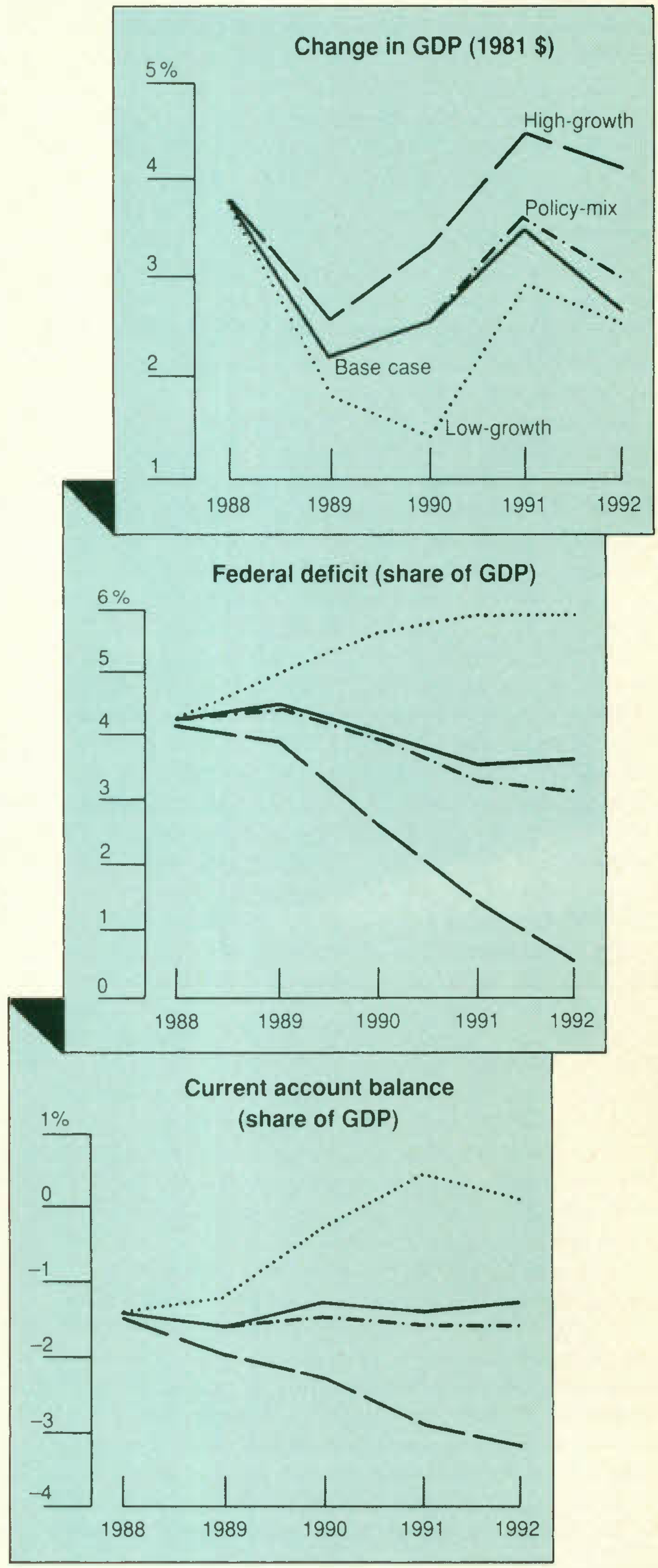
Balance of payments

Canada's balance of international payments on the current account will remain in deficit during the 1988-92 period, averaging just under 1.5 per cent of GDP. This is due in part, the Council says, to the average real growth rate of about 3 per cent over the period, which will increase demand for imported goods. At the same time, the growth slowdown projected for the United States will inhibit Canadian exports early in the period.

Inflation

The most controversial issue in the medium-term outlook relates to the outlook for inflation, the Council says. It points to a number of unsettling indicators, including a renewed upswing in commodity prices (other than those for food and oil); some overheating in southern Ontario, particularly in the housing market; some evidence of labour shortages; an increase in the ratio of consumer debt to disposable income, now above its 1982 peak, and annual growth in the money supply, which until recently averaged 10 per cent.

In all, the upward pressure on prices and costs is greater than it has been since 1981, but the Council expects that inflation pressures will be contained. The rate of increase in consumer prices is expected to peak at just over 5 per cent in 1989, for three reasons. Monetary policy will lean against any upswing in prices and costs; relatively abundant supplies will restrain oil and grain prices; and many wage and price decisions will be influenced by the painful lessons of the 1981-82 recession.



Labour productivity

Productivity growth over the past six years has diminished the imbalance between wages and productivity that occurred in the 1970s, when real wages accelerated but productivity growth stagnated. That means the fundamentals are in place to permit a rise in real wages in concert with future gains in productivity, the Council says. But growth in labour productivity is expected to average less than 1 per cent over the 1988-92 period. Some strengthening is expected to follow the growth slowdown of 1989-90, but, generally, the outlook for productivity is not promising, the Council adds.

Unemployment

The unemployment rate is projected to average 7.6 per cent between 1988 and 1992. The slower-growth period in 1989-90 is expected to stall the downward trend in unemployment for a time, but when economic growth picks up again in 1991-92, the rate will drop to about 7 per cent.

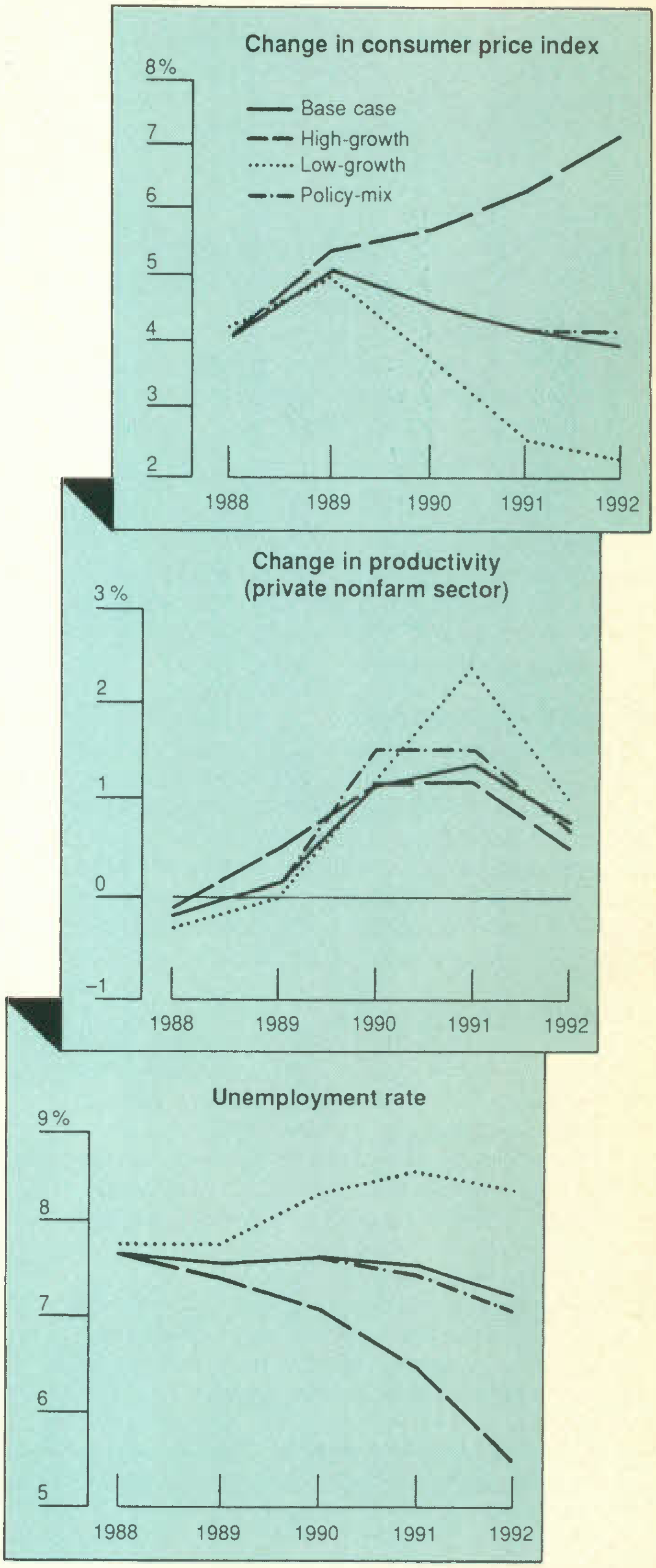
It has taken six years of economic expansion to get Canada's unemployment rate down from more than 12 per cent to slightly below 8 per cent. During the same period, the rate of inflation subsided from over 12 per cent to about 4 per cent. This represents substantial progress on both fronts, but the Council's analysis shows that it will be much more difficult to push the unemployment rate further down without, at the same time, causing upward pressure on prices.

Council research suggests that some sectors and regions of the economy are experiencing labour shortages despite relatively high unemployment rates because of a mismatch between workers' skills and employers' needs. Unemployment of this type is termed structural because it reflects the unemployment associated with the structural characteristics of the labour market, regardless of the pace of economic activity. If government is to reduce unemployment rates, it must put in place job training and labour-market programs aimed at increasing the supply of workers whose skills match those sought by employers. The challenge, in the Council's view, is to do so while keeping the economy growing at a moderate rate.

The Council's examination of structural unemployment indicates that it has been declining since 1982 and is expected to remain in the range between 7 and 8 per cent during the 1988-92 period. Since the actual rate is now in that range, the Council says that in the short run "it would be dangerous to try to reduce unemployment by stimulating economic growth" because the immediate outcome would be much more inflation, with relatively little reduction in unemployment.

Finally, the Council notes the dilemma facing policy makers: the economy is moving closer to the point where inflation pressures could become serious; high rates of unemployment persist and regional disparities have widened, even though the economy is operating at close to capacity; and the high levels of government debt and foreign borrowing leave Canada vulnerable to a slowdown and tie the government's hands in fighting unemployment.

Given these circumstances, the Council sees two priorities for the medium term. Governments must reduce their deficits, and they must focus more attention on the problem of labour-market mismatching.



Labour markets in transition

Over the past two decades the Canadian labour market has drifted into a situation where more unemployment and more job vacancies coexist because of an increase in the degree of labour-force mismatching (which occurs when the characteristics of unemployed workers do not match the requirements of the new jobs that are being created). While many factors can contribute to such unemployment, the most important for Canada in recent periods has been the industrial restructuring of the economy in response to changes in demand and technology.

Canada needs better-focused training programs if it is to speed up the decline in stubborn rates of unemployment, the Council finds.

Some job vacancies and unemployment will exist in a healthy labour market as individuals search among the available vacancies for the best fit of their skills and wage expectations, the Council explains. As the accompanying chart illustrates, however, this "natural" or structural unemployment rose dramatically in the early 1980s.

Commodity shocks

The shock of high oil prices in the 1970s had a major impact on demand in the economy. Overnight, the shift in demand from energy-guzzling to energy-efficient products caused significant growth for some firms and industries, while others saw the demand for their products evaporate. This situation was exacerbated by the second oil shock of 1979 and the events that followed, including high interest rates, the 1981-82 recession, and the drop in other commodity prices.

Many firms responded by rationalizing their operations. Overall, the movement from a goods-producing to a service-based system quickened. This was reflected in an acceleration of the rate at which jobs disappeared, as well as in a radical shift in the nature of the new jobs being offered. As a result, some workers in the goods industries have had trouble adjusting.

That interpretation of the increase in structural unemployment is supported by such indicators as the increase in long-term unemployment (defined here as that lasting 53 weeks or more). Such lengthy unemployment indicates a serious failure on the part of labour markets to match the unemployed with job vacancies.

Regional restructuring

Much of the increased disparity in regional unemployment rates is due to the variation among provinces in the pace and timing of the shift of employment from goods-producing to service industries, the Council finds. Sharp increases in structural unemployment occurred in the resource-based regions, with the Prairies and British Columbia experiencing the largest relative increases.

Finally, although recognizing its important social role, the Council also notes that the provision of unemployment insurance benefits has added to structural unemployment by affecting the willingness of individuals to work and the hiring decisions of firms. The contribution of unemployment insurance to provincial unemployment rates is largest in those provinces where regionally extended benefits are the most generous.

Service-sector growth

While the goods sector has been going through this transformation, most of the new employment that has been created is in the service sector. Seven out of 10 workers in Canada are now employed in this sector. Much of the growth in service-sector employment has occurred in business services (such as computing or engineering services) and in personal services (barbers or dry cleaners, for example), where the skill requirements tend to be very different from those in mining, manufacturing, and construction.

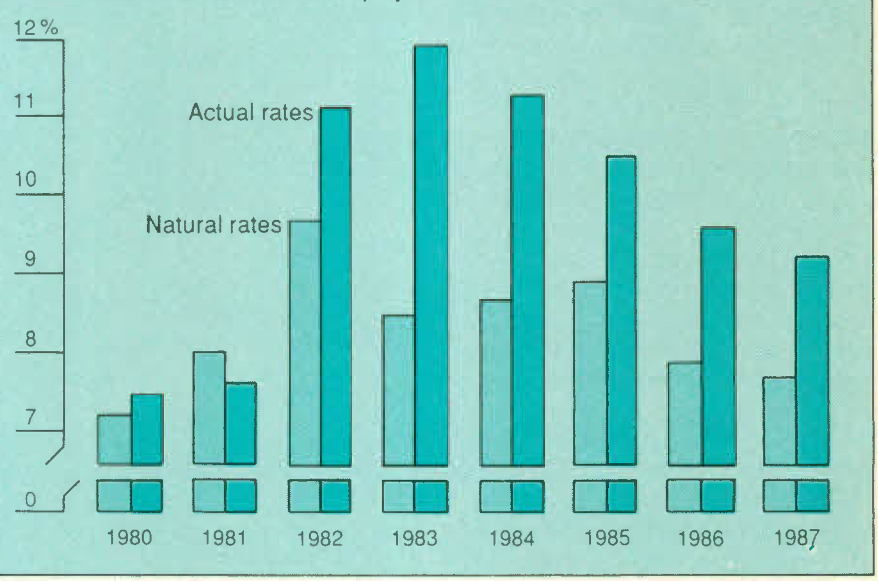
Skill requirements

A significant component of service-sector employment is likely to be in the low-paid and low-skill segment, the Council finds. But it points out that high proportions of these jobs are filled by young people and women. With the lower growth rates in female labour-force participation and the aging working population expected in the future, employers will be forced to upgrade the quality of these jobs, to recruit more older workers, or to press for increased immigration.

Overall, in order to attack the problem of labour-force mismatching at its roots, Canada will have to focus on programs and policies that help workers move from one industry or occupation to another.

The unemployment trends in the 1980s

Natural and actual rates of unemployment, Canada



A window on the longer term

Canada will face quite different challenges in the year 2000, but the economic policy priorities at the turn of the century will probably be remarkably similar to those of today.

In its Visions of Canada in the Year 2000 research project, the Council is looking ahead to the next millennium to determine the issues with which Canada will have to deal.

What has already become evident and will be increasingly important in the years ahead, the Council reports, are the growing linkages between national economies, the environment, and other global systems.

In the area of the environment, where problems often transcend national borders and threaten to impair future economic growth, this means that governments, acting alone, are unable to solve the problems. Without new, more cooperative approaches to reducing environmental degradation, the situation "could easily become chaotic," the Council warns.

The world economy

In the emerging world economy, the Council identifies five trends that will influence economic policy making in the years ahead. First, the economic gap between the industrial leaders and some of the successful developing countries will continue to narrow, primarily because of the rapid diffusion of knowledge and technology.

Second, while some Third World countries will fare well, those whose educational standards do not enable the people to make effective use of new technology or those in which there is a lack of either political stability or worker discipline are unlikely to break out of the pattern of poverty.

Third, the number of centres of substantial economic power is likely to grow over the next quarter-century. China, India, Brazil, and possibly (in light of recent political events) the Soviet Union and eastern Europe, are among those countries with the potential to become major economic powers, the Council says.

Fourth, economic convergence and rising living standards will make countries increasingly interdependent. That is already reflected in the pace of expansion of world trade, which has far exceeded the rate of growth of world output, the Council notes.

Finally, global markets for services are emerging. This extends international competition into activities that had been sheltered in the past – including telecommunications; and financial, engineering, management, and other consulting services. If the full benefits from these "tradable" services are to be obtained, the international community will have to work to reduce or abolish trade barriers in this area.

International governance

The complexity and unpredictability of global developments create a need for increased international cooperation; coordination; and, in some cases, harmonization of policies and practices.

In the Council's view, existing international institutions – the World Bank, the International Monetary Fund, and the General Agreement on Tariffs and Trade (GATT) – lack the mandate and resources to deal with many of the problems that transcend national boundaries. This is because the situations that these institutions were originally intended to manage have changed. Therefore, either the institutions will have to be strengthened or new ones established, the Council says.

Options for Canada

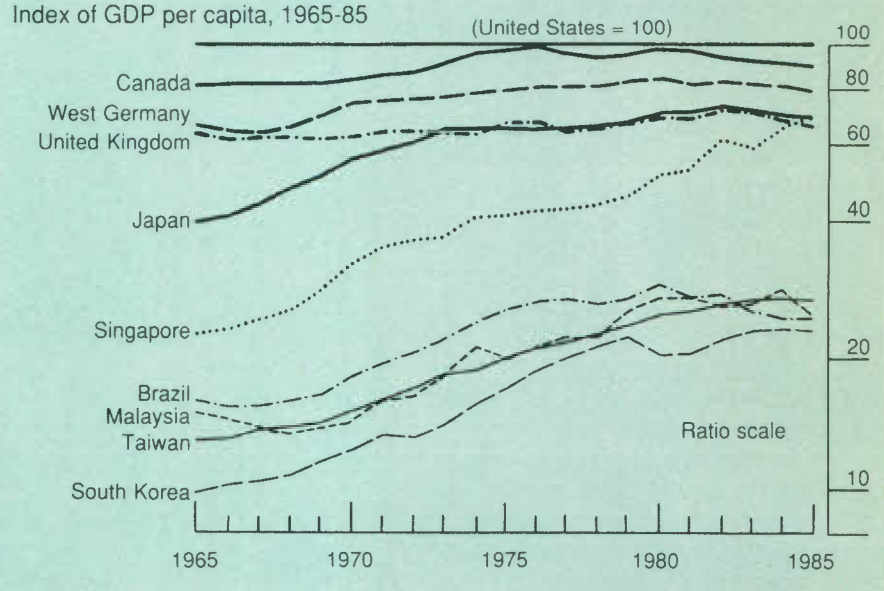
As international competition grows, Canada will increasingly be forced to focus its production activities on goods and services that are more knowledge-intensive and that embody greater value-added; low-cost producers will usually be found in the less-developed countries.

Given this context, there will be two related priorities for Canada. First, it must enhance its competitiveness in the international marketplace. Governments can contribute to that goal by helping to shape the rules of world trade and to open markets through trade negotiations. But it is industry that must be competitive.

Second, Canada must give greater priority to developing its human resources. In basic education, one key issue is curriculum – teaching the basic communication skills and the stock of knowledge needed to function in society, as well as the ability to learn, which will also be a key skill in vocational education. The private sector will need to regard training as an investment, and training will have to be seen as a continuous process, not as an occasional, one-shot event.

The convergence towards the United States

Index of GDP per capita, 1965-85



Priorities, targets, and objectives

Canada should get back to basics, with a fundamental improvement in many of the policies needed to help make it competitive in the years ahead.

The Council stresses the need for wise policy, not only out of a concern for competitiveness but also because of the evolution of an increasingly complex and fragmented world in the next few decades. Its preliminary look at longer-run issues suggests new challenges for Canada's social and political institutions – in particular, the growing international dimension to decision making, with far more complicated linkages between world economic, political, environmental, and demographic systems. Canada will be in a much better position to prosper in this environment if it has "low levels of government debt, strong productivity growth, low unemployment, and a higher-quality education system," the Council concludes.

In light of recent economic developments, the Council has reassessed its targets for Canada's economic performance over the medium term (see box). While some targets remain unchanged, others are revised to reflect a shift in emphasis. The Council believes that annual employment growth should be in the range of 1.5 to 2 per cent. A more desirable target for the unemployment rate over the medium term lies in the 5 to 7 per cent range. The inflation target must be reduced to 4 per cent or less. And the federal deficit should be cut to no more than 2.5 per cent of gross domestic product by 1992 – a significant reduction from the current 4.3 per cent.

Policy responses

The Council's base-case projections for 1988-92 suggest that Canada will fall short on several of these targets unless there are three important shifts in policy priorities. The first is to shift the medium-term policy mix, putting more restraint into fiscal policy and allowing monetary policy to be more "accommodating," it says. The Council explains that because of the government's weak fiscal position, the burden of combatting any threat of accelerating inflation would fall onto monetary restraint, through higher interest rates. That would slow investment and consequently weaken productivity and competitiveness. Therefore the undue reliance on monetary restraint has "adverse implications for the medium-term performance of the economy," it says.

The second priority is to focus far more attention on enhancing competitiveness through such levers as trade policy, technology, and education.

Monitor progress

Canada's record of developing and adopting new technology has been weak in comparison with that of its major trading partners, the Council notes. It urges the federal government to undertake a regular, ongoing survey to monitor technological change as a means of providing better standards and benchmarks against which to judge Canada's technological progress.

Furthermore, it recommends that firms, working through industry associations, develop a variety of productivity measures to enable companies and industries to compare their performance with that of their competitors, both in Canada and elsewhere. Much better productivity indicators are needed for the service sector in particular. The Council supports current efforts in this area on the parts of some firms and industry associations but strongly urges others to follow suit.

On education, the Council notes that whatever Canada does in the medium term to upgrade the quality and adaptability of its labour force "will have a big pay-off . . . down the road."

Improvements in education and training also fall under the Council's third policy priority: to strengthen human-resource development.

Labour-market programs

In the Council's view, the main objectives of the federal programs – the focus on the individual and the effort to decentralize decision making on the allocation of funds – are appropriate. But it also endorses the recommendation that structural reforms be undertaken to give Local Advisory Councils even more input to decision making (as well as making these groups smaller and more collegial). The government should also reassess its allocation of funds within the Canadian Jobs Strategy to place greater emphasis on training to reduce structural unemployment.

More generally, the Council sees a growing need for customized courses to meet the needs of local employers. Many colleges and technical schools have resisted this change, however. What is required is more coordination among educational bodies, industry, unions, and governments. Finally, the design of training programs should not presume that older workers cannot be retrained, the Council stresses.

Industry action

Industry has much to gain from a highly qualified and well-motivated labour force. It must take responsibility for effective training, job design, work organization, and compensation systems. On training, however, too much emphasis is placed on short-term courses. Human-resource planning should include a combination of in-house training, support for cooperative courses at educational institutes, and various types of training leave, the Council says.

TARGETS

1. **Productivity growth of 1.5 to 2 per cent a year.**
2. **Employment growth of 1.5 to 2 per cent a year in order to lower unemployment to a range of 5 to 7 per cent by 1992.**
3. **Real GDP growth of 3 to 4 per cent a year.**
4. **Annual inflation of 4 per cent or less.**
5. **Net capital inflows of about 2 per cent of GDP or less.**
6. **A reduction of the federal deficit to 2.5 per cent of GDP or less by 1992.**
7. **The maintenance and improvement of existing social policies.**
8. **Regionally balanced growth, employment opportunities, and social infrastructure.**

Multinationals welcome free trade

American subsidiaries in Canada are unlikely to close plants or to lay off workers in response to the free-trade deal with the United States.

At the same time, Canadian multinationals – which have become increasingly important in recent years – will be able to keep more jobs in Canada, according to a new discussion paper done for the Council's project on trade policy options (see *Au Courant*, vol. 8, no. 4). The paper, by University of Toronto international business professor Alan Rugman, focuses on the linkage between international trade and the international investment activities of both U.S.- and Canadian-owned multinationals.

The research provides new insights into the activities of Canadian-owned multinationals in particular. For one thing, these firms export about five times as much as they import from their U.S. subsidiaries. (That trade is partly offset by the purchases of U.S. subsidiaries in Canada from their U.S. parents.) Secondly, Canadian direct investment in the United States has been outpacing U.S. direct investment in Canada since 1975. Today, the Canadian stock of direct investment in the United States is valued at about 60 per cent of the U.S. stock in Canada.

U.S. subsidiaries

As for U.S. subsidiaries in Canada, Rugman discloses new evidence that calls into question the belief that many of these firms – originally attracted to Canada to avoid tariffs – will reduce operations or shut down once trade barriers are removed. Since U.S. subsidiaries in Canada export about 25 per cent of their output, "they can hardly be classified as being in Canada entirely" for that reason, he explains. "Many of the U.S. operations in Canada form part of a larger strategically integrated network of companies."

Furthermore, many U.S. plants in Canada have invested heavily in capital equipment, buildings, and other sunk costs that will minimize their sudden departure. Most of them also have access, among other things, to the production and marketing expertise of their parents; hence they will not lose their competitive advantage once trade liberalization occurs.

When trade barriers are removed, companies will reassess the competitiveness of producing in Canada against global marketing and production opportunities. Rugman believes that Canada will retain and attract foreign direct investment "if there is a good business climate." It will lose out, however, "if there are perceptions of arbitrary government regulations, taxes, tariffs, or a lack of national treatment for investment," he adds.

The favourable economic climate following trade liberalization "will probably lead to greater inflows of direct investment from third countries, including Japan and European nations," Rugman maintains.

Benefits to Canada

The opportunities for Canada's multinationals will grow with or without trade liberalization, the author points out. With free trade, more production will remain in Canada, adding to exports and jobs. Without it, more firms will invest in the United States and hence more jobs will be created there. Even in this case, however, Canadian subsidiaries in the United States will purchase a proportion of their inputs from their Canadian parent firms. Dividends will also be remitted to Canada, thereby increasing the national income and the potential for job creation.

As part of his research, the author studied 36 multinationals with net sales of $1 billion or more and assessed how they would react to trade liberalization by examining their competitive strategies. The results suggest that the managers of these firms are "well equipped to pilot their firms through the shocks of new trading regimes," Rugman finds. Both Canadian and U.S. multinationals in Canada are expected to undergo minimal adjustment, in fact, because their competitive advantages are not dependent upon trade barriers.

Survey results

These theoretical findings are supported by the results of a survey of the chief executive officers of the largest Canadian and U.S. multinationals operating in Canada (21 Canadian and 17 U.S. multinationals). Both groups are strongly in favour of trade liberalization, and they anticipate increased employment as a result. Neither group said it required a long phase-in period, a devalued exchange rate, or adjustment assistance. While each of them views trade liberalization as likely to improve their performance, the U.S. companies were more bullish. Together, the findings suggest that large multinationals will "bear the burden of adjustment to trade liberalization as a normal part of their strategic management," Rugman concludes.

Since multinationals account for about 70 per cent of bilateral trade between Canada and the United States, the prospect of trade liberalization is not as disruptive as some might expect. He notes that the single most important finding of this study is that trade liberalization will be welcomed by multinational enterprises.

In view of the vital role played by multinationals in bilateral trade and investment, the author believes that it is essential to involve senior managers of these corporations in the discussion of any new bilateral trading regime.

"Trade liberalization and international investment," by Alan Rugman. Discussion Paper No. 347.

Health-care policies safe

Canada's principal health-care policies are unlikely to be jeopardized by the Canada-U.S. Free-Trade Agreement.

On the question of universal medicare in Canada, the free-trade deal "need not be viewed as a threat," says University of Ottawa economics professor Pran Manga, in a new discussion paper done for the Council. The bilateral agreement could, however, adversely affect certain non-medicare services, such as nursing-home care and the medical-devices industry. It will also lead to more private management of health-care institutions and programs, including a greater number of for-profit hospitals.

Those who argue that free trade will threaten universal medicare contend that the United States will view Canada's publicly financed health-care system as a direct subsidy to all employers. But Manga points out that about 40 per cent of health-care services in the United States are publicly financed as well (compared with about 75 per cent in Canada). The purchase of private health insurance is also subsidized under the U.S. tax system.

Indirect costs

Furthermore, even though health-care services receive more direct subsidies in Canada than in the United States, employers in Canada pay indirectly through corporate taxes. (Employers in most provinces also pay some health-care costs directly, through contributions to workmen's compensation boards, while in three provinces and one territory they contribute to their employees' health-insurance premiums.) The suggestion that Canadian employers are more heavily subsidized than their U.S. counterparts would result in a "complex and ultimately futile comparison" of corporate tax rates and structure, among other things, Manga says.

Moreover, it would be ironic for the United States to press Canada to give up social policies that pursue the objectives of equality of opportunity – a principle that is enshrined in both the U.S. and Canadian constitutions. To concede to any U.S. demands calling for the demise of universal medicare or such policies as universal education "would be an abject capitulation of our sovereignty," he adds.

Private hospitals

The possibility of more for-profit hospitals in Canada is not a threat to medicare either, as long as provincial governments continue to control hospital budgets, Manga says. With this power, the provinces could regulate the profit margins and the number of for-profit, private hospitals. (Large multinational U.S. hospital corporations might, as a result, be less inclined to invest in Canada.) In addition, the provinces could enforce the codes and regulations that govern hospitals in providing services.

Nursing homes

Much of the nursing-home industry in Canada is already privately operated, Manga notes. The U.S. investment in this industry is likely to increase, as long as the Canadian industry remains profitable. With an aging population, there will likely be continuing growth in the demand for nursing-home beds in the future. But Manga is concerned about U.S. involvement in this industry, because U.S. firms "have not been well disposed towards government regulations." They are likely to resist existing Canadian controls and regulations, he warns.

In the area of dental care, the trend towards prepaid dental plans is likely to accelerate under the free-trade deal.

Medical costs

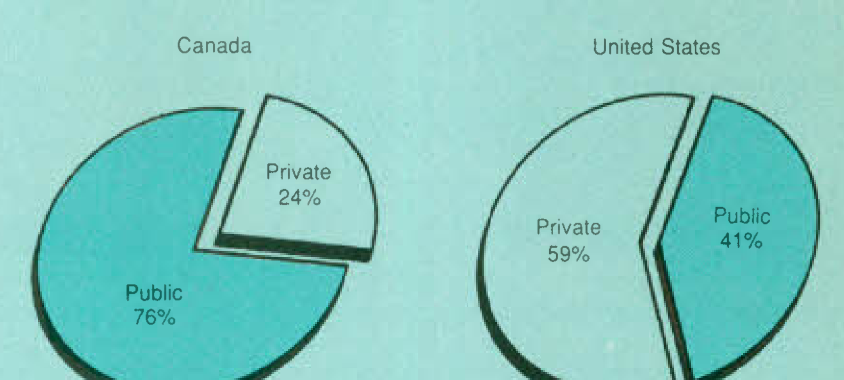
The free-trade agreement is unlikely to reduce health-care costs in Canada, since most equipment, drugs, and supplies already enter Canada duty-free. In particular, Manga looks at two health-care industries that involve the production and trade of medical goods. In the medical-devices industry, he finds that the free-trade deal is likely to dash any hopes of expansion in Canada. The removal of tariffs may adversely affect the investment decisions of U.S. firms by making it less attractive for them to manufacture products in Canada.

In the pharmaceutical and biological-products industries, the free-trade deal will "at best preserve the status quo," Manga concludes. Much of the pharmaceutical industry is foreign-owned. The biological-products subsector is made up of very few firms and is largely Canadian-owned. Because the pharmaceutical industry lacks a basic, pharmaceutical fine chemical (fermentation) industry, it imports active ingredients, then formulates and packages them for the local market. This is a major constraint to the development of an advanced biotechnology-based industry.

"The Canada-U.S. Free-Trade Agreement: Possible implications on Canada's health care systems," by Pran Manga. Discussion Paper No. 348.

Financing health-care costs

Private and public expenditures as a share of total, Canada and the United States, 1984



New members appointed to the Economic Council

Alan Borger is President and Chief Executive Officer of several Manitoba-based firms including Borger Industries Ltd. and Ladco Company Ltd. A graduate of the University of Manitoba, he is a former director of the Winnipeg Symphony Orchestra and a past president of the Prairie Road Builders Association and the American Public Works Association.

Thomas Courchene was recenlty appointed Director of the School of Policy Studies at Queen's University, after serving as a Professor of Economics at the University of Western Ontario for many years. He has also served as Chairman of the Ontario Economic Council, as Senior Fellow of the C. D. Howe Institute, and as a member of the editorial board of the Fraser Institute. He is a graduate of the University of Saskatchewan and of Princeton University and has written widely on Canadian economic and social policy.

Marcel Pepin is Professor Emeritus of Labour Relations at the University of Montreal. Active in the labour movement for many years, he is former president of the Confederation of National Trade Unions and of the World Confederation of Labour. He is a graduate of the Montreal Seminary and Laval University and has been a member of the North-South Institute since 1982 and has also served on the board of directors of l'Imprimerie Populaire Ltée.

Léon Courville is Executive Vice-President of the National Bank of Canada. He was Director of the Institute of Applied Economics and Professor Emeritus at l'École des Hautes Études Commerciales before joining the National Bank as Vice-President and Chief Economist in 1984. He is a graduate of Collège André Grasset, l'École des Hautes Études Commerciales and Carnegie-Mellon University.

People, social change, and pensions

Council Deputy Chairman Harvey Lazar was asked to speak about the impact of changing demographics and social trends on Canada's pension system at the Canadian Pension Conference in Vancouver recently. Following is an edited version of that speech.

For some years now policy makers have been concerned with the impact of changing demographics and social trends on our pension and benefits system. When large numbers of the baby-boom generation reach retirement age, for example, it is argued that they will constitute an increasingly heavy burden on the relatively small labour force at that time. Does "intergenerational equity" – the concept of fairness between generations – require us to alter the system now, in view of the possible burden on future workers?

One way of looking at the impact of demographic developments is to examine "dependency ratios" – the number of young and old people (below age 20 and above 65) relative to the number of people of work-force age. I have chosen instead to focus on the size of the dependent groups (young and old) as a percentage of the actual labour force and of the total population. What this shows is that the proportion of people in the labour force 40 years from now relative to the total population is expected to be roughly the same as it is today. The ratio of those aged 65 and older, on the other hand, will be roughly 2 1/2 times higher. Obviously this has implications for social expenditures in the years ahead.

Social expenditures

To estimate the impact of the rising number of elderly on social expenditures in Canada, the assumption has been made that existing expenditures have been frozen, either at current per-capita benefit levels or at the current level of use. For example, the numbers assume that 40 years from now an 80-year-old person will use the same amount of health services as an 80-year-old does today.

In this hypothetical scenario, social spending would rise from 21 per cent of gross national product (GNP) in the 1980s to just under 30 per cent by the year 2031. Income benefits for the elderly would increase by almost 300 per cent, and health-care costs would rise by nearly 80 per cent. The costs associated with the young (such as child benefits and education) would fall by less than 20 per cent.

On the other hand, the economy is also likely to continue growing. Thus productivity growth will be crucial to the size and affordability of social programs. For example, even a 1-per-cent annual growth rate in productivity – low by historical standards – would reduce the social-spending burden to below 20 per cent of GNP by the year 2031. With attention to productivity growth, the demographic trends alone are unlikely to overwhelm future generations of workers and taxpayers.

> ***With attention to productivity growth, the demographic trends alone are unlikely to overwhelm future generations of workers and taxpayers.***

At the same time, whether or not the costs being passed on to future generations are fair will depend on the totality of the assets and liabilities that are bequeathed to them. On the asset side, that legacy will include the state of our environment and the quality of our work force, for example. On the liability side, the huge public debt could remain a problem in the years ahead.

Social trends

As for social trends, there are a number of developments that may impact on the benefits system in the future. One is the trend towards early retirement. For example, with retirement fixed at age 60 instead of 65, the old-age dependency ratio in the year 2031 would increase by almost a third. Another development is the growing number of working women, which has increased the size of the labour force. But this has also been accompanied by a fall in the birth rate, which could affect dependency ratios in the future. Furthermore, women's preferences in the future are unknown. For example, would universal day-care increase the birth rate without a significant drop in female participation in the labour force?

The changing nature of the traditional family unit also has implications for the future of the benefits system, as does the changing face of poverty in Canada. In regard to the latter, poverty among the elderly has decreased markedly over the past 20 years; their incomes have nearly doubled over that period.

Possible impacts

What are some of the possible impacts of these trends? First, since the elderly are no longer among the neediest groups in society, major increases in public pension programs seem most unlikely (particularly in light of the tight fiscal position of governments). Second, there will be continued pressure to rationalize social expenditures, including a debate on the future of the Old Age Security program. Third, in view of the changing economic role of women, the pressure to introduce a homemaker pension could subside. With fewer homemakers, on the other hand, such pensions could also become more affordable. Fourth, the demands on the benefit system will become more varied, in order to meet the needs of different lifestyles. Finally, the benefit system may become more "individualized"; benefits will accrue to the individual regardless of marital status.

Other trends

Trends in pension coverage, portability, and indexing will also determine how well future pensioners will fare in their retirement years. As for coverage (including both pensions and registered retirement savings plans), it is growing. Portability has improved. And while indexing for inflation remains a thorny issue, progress has occurred. It is still unclear whether the public and private retirement income system is large enough for future generations of pensioners. But, on balance, Canada is at least moving in the right direction.

S·P·E·A·K·I·N·G · O·U·T

Despite five consecutive years of economic growth since the 1982 recession, high unemployment persists in some regions of Canada.

Even nationally, the unemployment rate has averaged much higher in recent years than it did over the past few decades. It rose from about 4 per cent during the mid-1970s to about 9 per cent in 1987. From 1982 to 1986, it exceeded the 10-per-cent mark, reaching a high of 12.8 per cent during the first quarter of 1983. Only recently has the unemployment rate begun to decline. What accounts for the high and persistent rate of unemployment? The Economic Council is examining that question as part of a new project on unemployment issues. To learn more about it, *Au Courant* spoke with project director Surendra Gera.

Au Courant: *Why is the Council undertaking this project?*

Gera: The experience of the 1980s has been one of high and persistent unemployment. It has led to a number of worrisome developments in the Canadian labour market. The divergence in regional unemployment rates has grown over this period primarily as a result of the recession of 1981-82 and the uneven recovery thereafter. There has been a dramatic increase in the proportion of long-term unemployed (individuals who are continuously unemployed for a year or more). While unemployment rates have been declining since 1985, the average duration of unemployment and the number of individuals who experience long-term unemployment remain high. We want to find out why unemployment has gone up and why it has become so persistent.

Au Courant: *What will the project examine in particular?*

Gera: The project will look at various issues related to unemployment and, for example, review the origin and development of the "full-employment" objective in Canada. The full-employment objective in Canada was set out in the White Paper on Employment and Income in 1945. The objective was generally to achieve a level of employment at which everyone who was able and willing to work could find a job. Is that a valid

Surendra Gera

objective today? What trade-offs are involved in pursuing a full-employment strategy? How real and inevitable are those trade-offs?

Second, we shall examine the current high level of unemployment to determine whether it is mainly cyclical, or structural in nature. By cyclical I mean the unemployment associated with a cyclical downturn in economic activity, such as the 1981-82 recession. The term "structural unemployment" refers to the unemployment that remains even after the recovery in economic activity that follows a cyclical downturn. This type of unemployment arises primarily as a result of a mismatch between labour demand and labour supply. For example, in recent years the shift in economic activity from the manufacturing sector to service industries has contributed to structural unemployment.

Any unemployment other than cyclical is also referred to as "the natural rate of unemployment." Economists like to call this natural rate the "nonaccelerating inflation rate of unemployment" (NAIRU). Most economists believe that every economy has a certain rate of unemployment that is consistent with stable rates of inflation. The gap between the actual unemployment rate and the NAIRU serves as an indicator of the slack in the labour market. The NAIRU can vary over time because of such factors as the demographic composition of the labour market, the level of skills within the labour market, and changes in the laws pertaining to unemployment insurance benefits. We shall determine whether the current unemployment rate is still slightly above the NAIRU. We also want to look at the NAIRU from a regional perspective because of the considerable differences in unemployment rates across regions.

Third, an essential feature of the unemployment problem is its dynamic character. By this, I mean that individuals are constantly moving into and out of periods of unemployment as they change jobs, for example. It is important for policy makers to know how much of the unemployment is long-term and whether that long-term unemployment is sensitive to cyclical conditions. If that should be the case, then long-term unemployment should diminish as the economy recovers from a cyclical downturn. A major question in this regard concerns the time it takes for long-term unemployment to decline. In Canada, the proportion of long-term unemployed has fallen sharply in 1988, six years after the recovery. Nevertheless, the proportion remains high compared with its pre-1981 levels.

Fourth, we shall be investigating whether high unemployment stems from the failure of real wages to adjust to changing labour-market conditions, particularly to changes in the rate of productivity growth. For example, in the recent recession workers may have been laid off instead of taking wage cuts. Similarly, employers may continue to pay high wages during an economic downturn in order to maintain productivity and to avoid the costs associated with firing and the eventual hiring and training of new workers when the economy picks up again.

Au Courant: *At this point what does your research indicate as the reason for unemployment being so much higher today than in the past?*

Gera: Our research is still in progress. Some of it indicates that the economy is operating at close to the NAIRU and that there is not much room to exercise expansionary fiscal or monetary policies (to reduce unemployment) without reigniting inflationary pressures. The research shows that the structural imbalances – the mismatch between vacant jobs and the skills or location of unemployed workers – grew over the 1966-86 period. A large proportion of the rise in structural unemployment occurred from 1976 onward. The research also shows that regional economic disparities and the increasing proportion of long-term unemployed have contributed to the growth in structural unemployment. At the same time, in a dynamic economy with constantly changing patterns of demand, some amount of structural unemployment is inevitable.

Au Courant: *How do we deal with structural unemployment?*

Gera: Since structural unemployment generally arises because of a mismatch between workers and jobs, in terms of their skills or location, obviously we need to have the right training policies to encourage skill development, as well as mobility. Structural unemployment cannot be reduced permanently through expansionary macroeconomic policies. Microeconomic policies such as training programs, on the other hand, can ease the adjustment process in matching workers and jobs. In this regard, for example, it is important to concentrate on skill-development programs to develop the service-sector work force, because that sector accounts for an increasingly large proportion of employment.

Another factor that has become important in terms of structural unemployment is that our resource-dependent regions have experienced a terms-of-trade loss. As a result, those regions have suffered a real income loss, and many jobs have simply disappeared. In this case, training and worker-mobility programs may not be the most appropriate solution. Instead, governments have to determine how they can reduce the sectoral shocks of recent years (the downturn in oil prices and some agricultural prices, for instance), perhaps by encouraging economic diversification.

To the extent that the growth in the number of long-term unemployed contributes to structural unemployment, we need to consider specific policy measures to encourage employers to hire the long-term unemployed. Potential employers may be reluctant to hire someone who has been out of work for many months. At the same time, individuals who have been unemployed for long spells may become discouraged and reduce the intensity of their search for work.

The mismatch between vacant jobs and the skills or location of unemployed workers has grown over the 1966-86 period.

Au Courant: *How does Canada's record of unemployment fare against that of other countries?*

Gera: The 1980s have seen a significant rise in unemployment in all the developed countries. The unemployment rate for countries in the Organisation for Economic Co-operation and Development was 8.3 per cent in 1986 – up 56.6 per cent from the rate prevailing in 1979. Since the beginning of the current international recovery in the early 1980s, only three countries – Canada, the Netherlands, and the United States – have registered a relatively significant decline in their unemployment rates. Even for these countries, however, the current rates are very high in comparison with those prevailing in 1979. While unemployment has drifted steadily upward since the 1960s, that trend has been much more marked in Europe than in North America and Japan.

There has been a dramatic increase in the proportion of long-term unemployed.

Au Courant: *What will the output of your project consist of?*

Gera: Most of the output will be in the form of working papers and research studies. It will also provide input to the Council's Annual Review of the economy and to the Council's project on employment and the service sector economy. The mandate of the project is basically to update the research on unemployment.

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