ECONOMIC COUNCIL OF CANADA

Performance and Potential

mid-1950's to mid-1970's

September 1970

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99464—1

7th Annual Review

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Introduction

During the past few years, the Canadian economy has grown somewhat less rapidly than its potential rate of growth, particularly in 1970. Unemployment has risen, and employment growth has slowed. The volume of private capital investment has increased very little since the end of the investment boom in 1966. In spite of slower growth and some increase in economic slack, price and cost advances have remained relatively high. On the other hand, Canada's international payments position has continued to be strong.

What has been the nature and significance of such developments, and in what longer-term perspective should they be viewed? To what extent is the Canadian economy falling short of its potential? What are some of the principal lessons of Canada's economic experience over the past decade or so, and what are some of the main performance challenges for the 1970's? What should be done to enhance future prospects of achieving good performance *simultaneously* in relation to all of the basic economic and social goals? These are some of the questions to which we address ourselves in this report.

In our Act, the main duties of the Council were set forth under a basic mandate requiring us to advise and recommend, "how Canada can achieve the highest possible levels of employment and efficient production in order that the country may enjoy a high and consistent rate of economic growth and that all Canadians may share in rising living standards". Under these terms of reference, and on the basis of a consensus among our heterogeneous membership, we have periodically published assessments of the nation's future economic potentials for growth and development, keeping fully in mind the other basic economic and social goals indicated in our Act. Similarly, we have also regularly published an appraisal of the economy's performance in relation to such potentials and goals. The central purpose of such appraisals has *not* been to analyse current business conditions and the short-term economic outlook, but rather to consider the underlying progress of the economy towards good future performance. Our concern has been essentially focused on developments tending to produce significant or persistent departures from the kind of performance required for consistent future attainment of our basic social and economic goals. The five basic goals with which we have been centrally concerned are: full employment, a high rate of economic growth, reasonable stability of prices, a viable balance of payments, and an equitable distribution of rising incomes.

In the past, our appraisals of the performance of the economy have been included in our Annual Reviews. A year ago, we concluded that such an appraisal could be undertaken in a more useful and orderly way in a separate report this year, especially since we wished to focus attention on a broad assessment of the past decade or so.

Although this report focuses attention rather narrowly on the *performance* of the economy, we wish to emphasize strongly at the outset that *high standards of economic performance are not ends in themselves.* The ultimate purpose of achieving sustained, balanced and widely shared growth at high levels of employment is to generate the *means* for more fully satisfying the diverse needs and rising aspirations of Canadians—not only in material terms, but also in terms of a better quality of life for individuals, families, communities, and our society as a whole.

The Search for Better Economic Performance

The past decade has been one of worldwide accentuation of interest in the question of how to achieve and sustain good national and international economic performance. In Canada, many actions have been aimed at improving the performance of the economy in relation to the more ambitious economic and social goals that Canadians have sought to attain. In fact, the establishment of the Economic Council in 1963 was one of these actions. It was, in part, a direct response to the widespread concern in Canada in the early 1960's about the poor performance of the economy.

On a world scale, the 1960's were years of considerable innovation in approaches to the promotion of strong and stable growth at high levels of employment. Behind such innovation was a general strengthening of national efforts and institutions for advising on economic performance and potentials. And behind these, in turn, were major and far-reaching improvements in the information and analytical bases for such advisory activities.

Also, the past decade has witnessed considerable advances in co-operation among countries to define growth objectives, to deal with instability, to create international conditions favourable to the more consistent achievement of national economic aims, to harmonize some aspects of national economic policies, and to focus greater attention on the needs of the less-developed countries. The growth targets of the Organisation for Economic Co-operation and Development, the Kennedy Round of tariff negotiations under the General Agreement on Tariffs and Trade, the introduction of a system of Special Drawing Rights under the International Monetary Fund, the Indicative World Plan of the Food and Agriculture Organization, and the establishment of the United Nations Conference on Trade and Development are some examples of these new developments. All of these have occurred in the context of relatively strong and sustained world economic growth, a rapid rise in international trade and capital flows, rapid dissemination of new knowledge and technology, substantial mobility and migration of manpower (especially skilled and professional manpower), the rapid growth of multinational corporations, and greatly increased international economic interdependence (especially among the more industrially advanced nations).

Within Canada, too, the 1960's were years of considerable policy and institutional innovation aimed at improving both the performance and potentials of the economy. In particular, rising investment in *people* became a dominant feature of the decade, reflected especially in the very rapid growth of expenditures on education and health care. Also indicative of new initiatives were: the substantial build-up of resources for manpower and labour market programs; the evolution of a series of programs to reduce Canada's large and persistent regional disparities; new trade and other measures aimed at improving efficiencies through longer production runs in Canadian manufacturing; an attempt to moderate inflation through voluntary restraints; new steps to promote the more effective development and use of the powers of science and technology in the interests of Canada's economic and social goals; and a more explicit and co-ordinated government role, both federal and provincial, in consumer affairs. Among the institutional expressions of these initiatives were the creation of such new federal departments as Manpower and Immigration (1966), Consumer and Corporate Affairs (1967), and Regional Economic Expansion (1969); such new agencies as the Science Council of Canada, the Science Secretariat, the Atlantic Development Council (replacing the earlier Atlantic Development Board), and the Prices and Incomes Commission; such new arrangements as the Automotive Agreement with the United States, the Program for Advancement of Industrial Technology, and the provisions under the Industrial Research and Development Incentives Act. Another highly significant development, with important implications for the evolution of planning in the federal government, was the emergence of the Treasury Board as a separate and substantially enlarged organization. Some of these developments are still very recent or are in process of change. Most of them were designed to affect the economy in the longer run, and no evaluation of their effects is attempted in this report.

The 1960's also witnessed the development of a number of Parliamentary Committees as important sources of information and education—including particularly such Senate Committees as those on Manpower and Employment, National Finance, Science Policy, and Poverty, and also such House Committees as those on Banking and Commerce, and on Finance, Trade and Economic Affairs. Important roles in the provision of policy advice and public education were also fulfilled by a wide variety of Royal Commissions and Task Forces, both at the federal and provincial levels.

In the provinces, a wide range of new steps were taken to promote improved regional economic performance. These included the great expansion of activities in education and health, the strengthening of institutional machinery for advising on economic performance and policies, the inauguration of new programs in such fields as industrial and resource development, and the establishment or expansion of provincial research councils and foundations.

In the private sector, too, the decade of the 1960's has been a period of significant changes and adjustments. Illustrative of some of the changes contributing to better performance of the economy have been the development of more widespread and sophisticated business planning in the fields of investment, marketing, manpower, and technological change, and substantial advances in the competitive capabilities of many industries.

Other important economic performance issues of the 1960's were: the growing concern about the supply of an adequate stock of housing, particularly low-income housing; and the growing attention to the problems of rapid urbanization and environmental pollution.

Behind these developments has also been a considerable improvement in the resources and machinery for appraising economic questions and developments, as well as growing public discussion and debate about economic affairs.

Yet, for all these developments and advances of the 1960's, much remains to be learned about how to assure consistently better economic performance within national economies and on a world basis. The Canadian economy now is not performing as well in some respects as in many of the years in the 1960's. Most other industrially advanced nations are also experiencing serious performance problems—especially problems of persistently strong price and cost increases. Further, throughout much of the developing world, troublesome problems remain about how to achieve adequate and sustained rates of economic growth. Nevertheless, at least in the more industrially advanced countries, there appears to have emerged an increased confidence in national capacities to sustain reasonably good growth performance. This has undoubtedly been a significant factor in the shift of emphasis to other economic issues—in particular, to growing concern about how to bring about a better use of available economic resources to satisfy changing human aspirations in an increasingly complex, urbanized, technologically advanced society.

Basic Issues in Assessing Performance

A good deal of discussion and debate about the performance of an economy still takes place on the basis of highly oversimplified (and frequently partial and inadequate, if not questionable) criteria. Faster expansion is not always better than slower expansion. Labour markets can be too tight as well as too slack. Both price increases and price declines have important roles to play in well-functioning markets. Reduced deficits or increased surpluses in a nation's balance of trade in goods and services are not necessarily "good", or the opposites necessarily "bad". The performance of an economy must, in fact, be viewed in the context of a comprehensive, complex and interrelated set of criteria which have regard to *potentials* and *goals*.

Performance and Potential

The key questions about such performance are not those which ask whether certain "performance indicators" are going up or down, or are changing rapidly or slowly. Rather, the key questions should ask what we can learn from the actual progress of the economy in relation to what might have been possible, and what advance we are making towards the objectives which we could reasonably seek to attain in the future.

In this context, the following four important points need emphasis:

—performance and potentials are interrelated;

—both may be substantially influenced by international conditions and developments;

—both need to be viewed in a long-term rather than a short-term perspective; and

—both are affected by a myriad of decisions, actions, and attitudes in a modern industrial economy.

Regarding the first of these points, the *potential* for growth may be affected by the actual performance of the economy when the two deviate over an extended period. For example, when substantial economic slack persists, investment in both physical capital and human resources may be curtailed; research and innovative activities may be constrained; confidence and risk-taking essential for dynamic growth may be impaired; and rigidities of various kinds may be inserted into the economic system as governments, business firms, labour unions and other organizations seek ways of moderating the hardships arising from slow-growth conditions.

Conversely, excessive pressures tending to push an economy hard against its production potentials can also impair performance and, indirectly, future potentials. These pressures may create imbalances and distortions, give rise to unrealistic expectations, weaken the disciplines essential for well-functioning markets, induce balance-of-payments strains, and impose burdens on those with fixed or slowly rising incomes.

The performance of an economy therefore needs to be measured against the *moving target* of its expanding potential output capabilities. Moreover, the steady and stable advance of actual output close to potential output would appear to offer the best route towards enhanced future potentials—that is, potentials for making reasonably full and increasingly efficient use of the nation's productive resources.

A second important issue in assessing both the performance and potentials of the Canadian economy is that these cannot be considered in isolation from the international economic environment. In our *Third Annual Review,* we noted:

> Since the earliest days of settlement, Canada's economic development has been profoundly influenced by external economic conditions and forces. Many strands have linked the Canadian economy to the world economy—trade and investment, migration and travel, growing organizational links in business, labour, agriculture and the professions, intergovernmental consultations and Canadian membership in international institutions, international flows of knowledge and technology, world-shrinking improvements in transportation and communications, and many less-obvious external connections. The country has today, and will continue to have into the future, an economy which is strongly influenced by changes in the international economic environment.

In this report, we continue to emphasize the critical importance of international economic conditions.

A third basic issue is that appraisals of both the potentials and the performance of an economy should properly be set in a medium- and longer-term perspective. Increasingly, economic research, analysis and experience suggest that while a complex modern economy may, from time to time, experience shorter-run variations in performance—such as fluctuations in productivity growth and employment—a *quick* improvement in performance is not easy to achieve in a *consistent* way in relation to all of the fundamental performance goals. For example, to raise the potential growth rate of the economy by one percentage point over a period of five or ten years is not a small challenge but a very *major* one. Similarly, to attain a better reconciliation than in the past between high employment and reasonable price stability is also an *extraordinarily difficult* challenge, not one that can be readily achieved with a few "right" policy decisions. Also the task of attaining a more equitable distribution of rising incomes—such as the narrowing of regional economic disparities and the elimination of poverty through wider participation of low-income regions and groups in Canada's development—is an *immense* task for which there are no simple solutions.

A fourth issue requiring emphasis is that both the potentials and the performance of a modern industrial economy are determined by a wide range of decisions and attitudes. The federal government, the provincial and municipal governments, a large and growing number of governmental agencies, business enterprises, labour unions, private institutions and organizations of many other kinds, as well as individuals, all play significant roles in determining potentials and performance. This has also been a repeated theme in our earlier work. It continues to be one here. It means that when the performance of an economy is less than satisfactory, realistic and objective appraisal of the problems will seldom, if ever, suggest that "one group of villains"—"government" or "business" or "labour" or "foreigners"—can be blamed. It also means that good performance is not simply determined by "one group of saints"; its roots will be found in well-informed and forward-looking decisions in many different quarters, as well as in a generally favourable international setting. And for such decision-making, effectively working systems for policy co-ordination are essential. In other words, good performance is everybody's business.

2

Major Features of Performance

The purpose of this section is to evaluate and place the performance of the Canadian economy in longer-term perspective.

In 1956, there was virtually no economic slack in either Canada or the United States. Both economies were operating close to potential. In both, price increases had become troublesome. A decade later, in 1966, both economies were again operating at potential, and price increases had again emerged as a major problem. Between these years, the North American economy experienced a rather severe recession in 1957-58, an abortive recovery in 1958-59, another but milder recession in 1960-61, and a long upswing—hesitant in its earlier stages, but gaining momentum and vigour—through the mid-1960's. For an extended period in the late 1950's and early 1960's, both the Canadian and U.S. economies performed poorly in relation to their potentials, with slow growth and underutilized resources. This situation was most pronounced in 1961 when unemployment was over 7 per cent in Canada and $6\frac{3}{4}$ per cent in the United States. Against the background of this large degree of economic slack, a reasonable degree of price stability was restored, and remained for a time.

Since 1966, the Canadian and U.S. economies have had a rather mixed pattern of similarities and differences, with perhaps more differences than in any earlier comparable periods. Strong demand pressures kept the U.S. economy pressed hard against its potentials from 1966 into 1969; only within the past year has a small amount of slack emerged. The Canadian economy remained slightly below its potentials in 1967-69, and a relatively larger degree of slack now has emerged. In this period, price and cost increases have represented a serious problem in both countries, more so in the United States. Unemployment has been more of a problem in Canada.

The Broad Patterns of Demand Change

The following brief sketch of salient features of demand changes over the past decade and a half will provide a useful background for appraising performance. Some of the major elements underlying the changes in total demand in Canada between 1956 and 1969 are indicated in Chart 1.

The *average* rate of growth in the *volume* of total output that it was possible to achieve over this period without generating severe strains (that is, the average *potential* rate of growth) was about $4\frac{3}{4}$ per cent—somewhat less in the first part of the period and somewhat more in the latter part (mainly because of the accelerated growth in the labour force beginning early in the 1960's). A discussion of the *actual rate* of growth in relation to the *potential rate* follows in the next section.

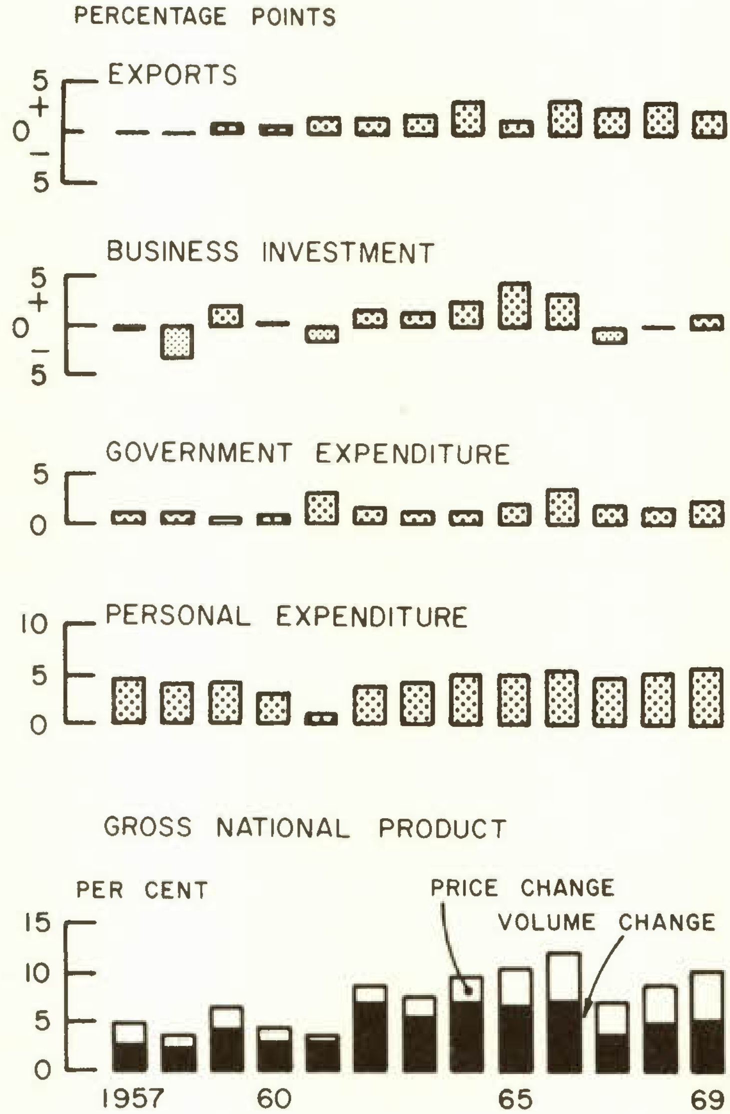
Chart 1 illustrates the importance of swings in business investment in fixed capital and inventories, which are closely associated with variations in the underlying rate of growth of total demand. Exports were weak between 1956 and 1960 but, during most of the 1960's, were a major expansive force. Business investment was weak from 1957 to 1961 and again from 1967 to 1969. Due partly to a catching-up process, it rose strongly from 1963 to 1966 at a rate that was clearly unsustainable for the longer term. The combined expenditures of all levels of government made only relatively small direct contributions to the growth of demand for goods and services in the latter part of the 1950's and in the early 1960's, except for the sharp advance in 1961. In the latter half of the 1960's, the contributions of such expenditures were more important, the surge in 1966 being especially pronounced. Personal expenditures have been the most steadily expanding component of demand, although the sharp curtailment of consumer spending in the 1960-61 recession is clearly visible in the chart.

The bottom part of Chart 1 indicates the relative contributions of price and volume changes to the overall annual changes in the value of Gross National Product. For five or six years after 1956, price increases were responsible for a gradually diminishing proportion of the rise in the value of output as growing slack emerged. The rate

CHART 1

MAJOR SOURCES OF CHANGE IN VALUE OF GROSS NATIONAL PRODUCT, CANADA

(Year-over-year)



Note: The bottom panel shows the total percentage change in the value of the Gross National Product over the previous year. The other panels indicate the percentage point contribution of *selected* components to this change (other components not shown in separate panels, but included in the GNP totals, are imports and residential construction).

Source: Based on data from Dominion Bureau of Statistics.

of increase in the GNP price index dropped irregularly between 1956 and 1961 (a comparable drop occurred in the United States from 1957 to 1962). Clearly, however, the response of prices to conditions of slack in the North American economy is very slow. On the other hand, as slack was being reduced from the early 1960's through the mid-1960's, price increases constituted a rising share of the growth in the value of output, and this share has subsequently remained relatively high.

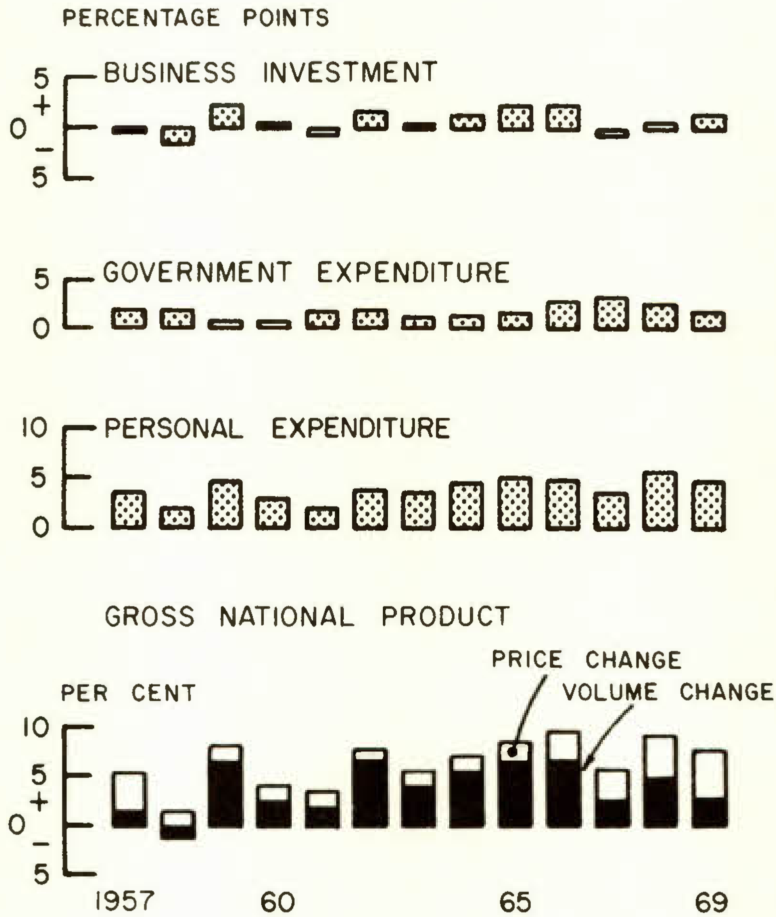
A major influence on the growth of demand for Canadian exports in the 1960's was the growing buoyancy of U.S. economic conditions. The principal determinants of total U.S. demand change from 1956 to 1969 are shown in Chart 2. The potential growth rate in the United States was lower than that in Canada, averaging about $3\frac{3}{4}$ per cent compared with approximately $4\frac{3}{4}$ per cent in Canada.[1] This disparity is almost entirely attributable to the higher rate of Canada's labour force and potential employment growth.

Business investment in the United States, as in Canada, was a major contributor to the rise in the value of output from 1963 to 1966. Even more important, U.S. federal government expenditure, particularly for military purposes, rose strongly between 1965 and 1968, imposing additional strains on an already fully stretched economy. Price changes contributed an increasing proportion of the rise in the value of GNP during those years. Curtailment of rising government spending in 1968-69 was a factor in the emergence of slower growth, and then a modest decline, in U.S. real GNP during 1969-70.

Economic developments in the United States had considerable influence on Canada's economic performance during the 1960's. Neither the pervasive slack that existed in the United States at the beginning of the 1960's nor the excessive demand and inflation that emerged in the last half of the 1960's represented ideal external conditions for the simultaneous achievement of all of Canada's basic economic goals. Thus an appraisal of Canadian economic performance as if these external conditions had been ideal is not realistic. What needs to be asked is whether Canadian performance *in the circumstances* could have been better. Because there were similarities in Canadian and U.S. performance in the period under review—as well as some

[1] Both rates are for total GNP measured from actual 1956 to estimated potential 1969 levels, in constant dollars. As in Canada, the U.S. potential growth rate was somewhat lower in the earlier part of the period, and somewhat higher in the latter part.

CHART 2
MAJOR SOURCES OF CHANGE IN VALUE
OF GROSS NATIONAL PRODUCT, UNITED STATES
(Year-over-year)



Note: The bottom panel shows the total percentage change in the value of the Gross National Product over the previous year. The other panels indicate the percentage point contribution of *selected* components to this change (other components not shown in separate panels, but included in the GNP totals, are exports, imports, and residential construction).

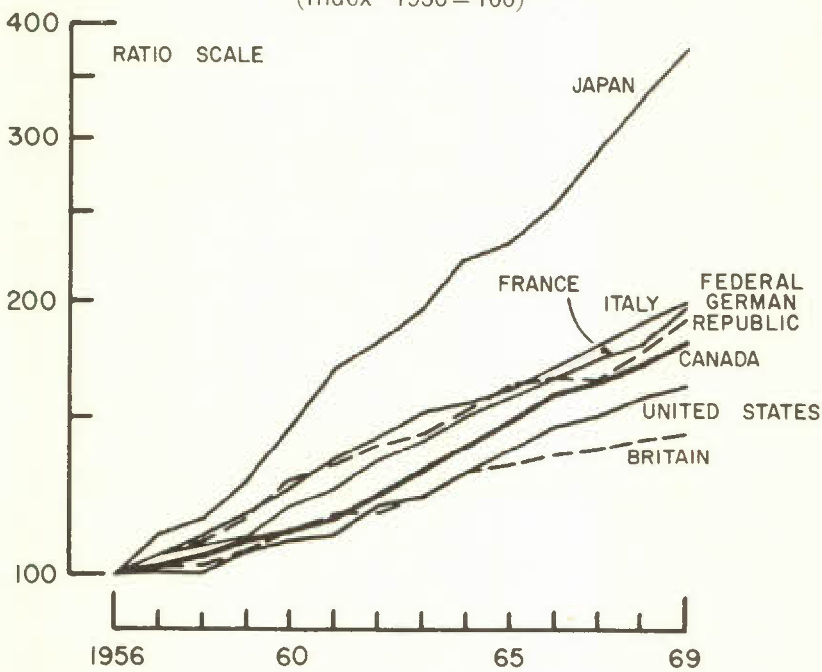
Source: Based on data from U.S. Department of Commerce.

notable differences—we find it useful to compare and contrast Canadian and U.S. experience in much of the analysis that follows.

International Comparisons of Growth

In the slowdown after 1956, the growth of real output in Canada and the United States fell significantly behind that in continental Western Europe and Japan (Chart 3). The momentum of growth in North America was regained after 1961, and for a number of years output expanded at a rate comparable to European rates. Since 1966, however, there has again been some moderation in growth in both Canada and the United States in relation to various other industrial countries.

CHART 3
GROWTH OF REAL OUTPUT, SELECTED COUNTRIES
(Index* 1956=100)

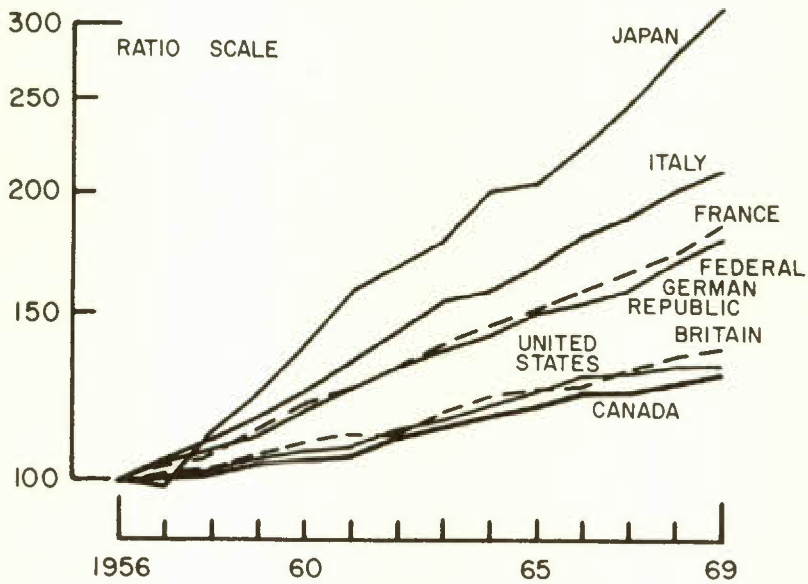


*Based on Gross National Product at constant prices.

Source: Based on data from Dominion Bureau of Statistics, United Nations, and Organisation for Economic Co-operation and Development.

In Japan, there has been a very high rate of growth in capital investment over the postwar period, along with substantial changes in the industrial structure of the economy, which favoured high-productivity industries. Strong efforts have also been made in Japan to introduce much more advanced techniques of production, so that there has been a very considerable increase in the overall efficiency of use of human and capital resources. This is reflected in the very strong growth achieved in output per employed person in Japan (Chart 4).

CHART 4
GROWTH OF REAL OUTPUT PER PERSON EMPLOYED, SELECTED COUNTRIES
(Index* 1956 = 100)



*Based on Gross National Product at constant prices.

Source: Based on data from Dominion Bureau of Statistics, United Nations, and Organisation for Economic Co-operation and Development.

In terms of both total output and output per employed person, the growth rates of the larger countries of continental Western Europe stand between the extremes represented by Japan and Britain. Although productivity growth (measured in terms of output per employed person) has been less dramatic in these European countries than in Japan, it has nevertheless been relatively high and well sustained. This has reflected, among other things, increased scale and specialization of production on the basis of greatly enlarged markets for many products, and substantial shifts of resources from relatively less-productive to more-productive employment.

The differences apparent in the growth of total output between Canada, the United States and Britain, as indicated in Chart 3, largely reflect differing rates of growth of labour force and employment in these countries. These differences largely disappear in a comparison of indexes of real output per employed person (Chart 4). The trend of growth in output per employed person in these three countries since the mid-1950's, although high by historical standards in each of them, has been lower than that in most other industrial countries.

Such international growth comparisons must, however, be examined with caution; there are considerable differences in the factors affecting growth in various countries.[1] It is particularly important to note that both Charts 3 and 4 depict comparative growth *rates,* and not comparative *levels,* of output, or output per employed person. Among the countries shown in these charts, some of those with the highest growth rates, such as Japan and Italy, still have the lowest average levels of output per employed person, while the United States and Canada, although they have had slower growth rates over the past 15 years, have the highest average levels of output per employed person. The faster rates of growth in output per employed person that are occurring in most other industrial countries are, however, tending to bring productivity and average real living standards in these countries closer to levels in Canada and the United States.

Looking to the future, the Organisation for Economic Co-operation and Development (OECD) has recently examined the growth potentials of its 22 member countries for the 1970-80 decade.[2] Taken together, these potentials represent a growth target amounting to a 65 per cent increase in total real output of OECD countries (compared with the earlier growth target of 50 per cent for 1960-70, and an actual output growth of over 55 per cent). These estimates of potential growth for the 1970's indicate a rate of 5.4 per cent a year for Canada—the fourth highest rate among the industrial countries, after Japan, France and Italy. At the same time, it should be noted

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[1] For an analysis of some of these factors, see Staff Study No. 28, *Canadian Growth Revisited, 1950-1967,* by Dorothy Walters, which updates earlier Staff Study No. 23, *Canadian Income Levels and Growth: An International Perspective,* by the same author.

[2] The estimate of total potential output for Canada is in line with estimates in our *Sixth Annual Review* which assessed Canadian growth potentials to 1975.

that this relatively high growth target for Canada is closely linked to the exceptional growth anticipated in the Canadian labour force and employment. Thus Canada does not rank among the leaders on the basis of the rate of growth of output per employed person.

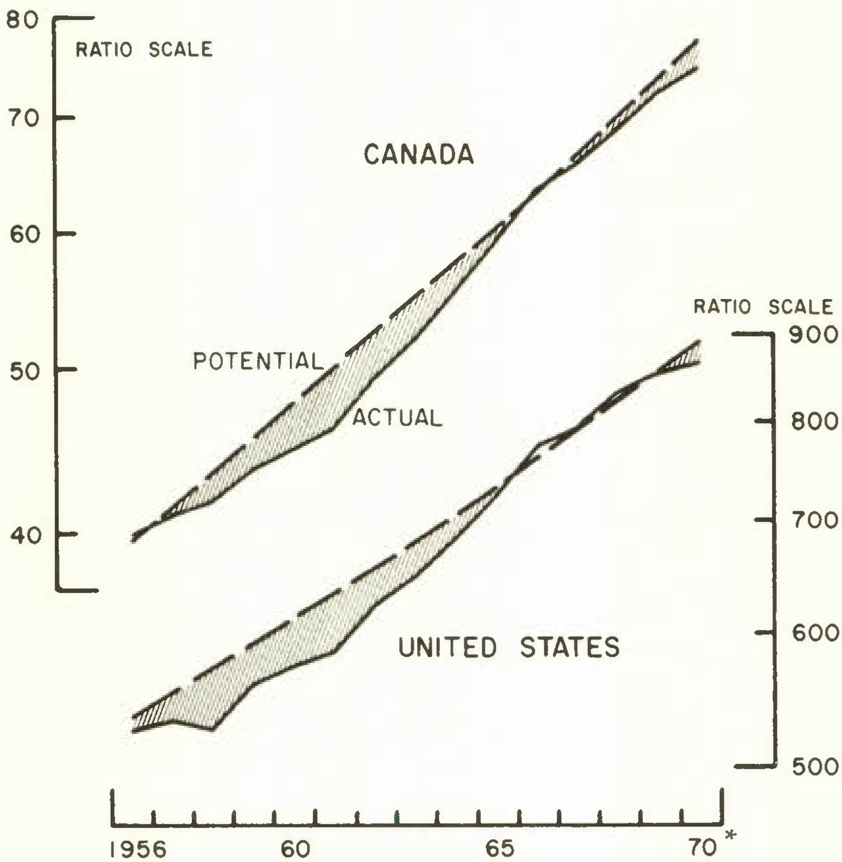
Actual Versus Potential Output

Assessment of a country's growth performance can best be made by considering the actual level and changes in output in relation to what could have been accomplished with reasonably full and increasingly efficient use of existing resources—in other words, through a comparison of *actual* with *potential* output. To say that the late 1950's and early 1960's were characterized by high unemployment and substantially underutilized production capacity in Canada and the United States is not sufficient for an adequate assessment of that period. Such an assessment requires some sense of the *quantitative magnitude* of the degree of slack. Estimates of *potential* or *high-employment* output, with which actual output may be compared, permit one to observe the approximate quantitative dimensions of shortfalls that may occur.

For North America, potential output is usually defined as the level of output corresponding with employment of 96 to 97 per cent of the labour force—i.e. with 3 to 4 per cent unemployment—and with the economy moving along the postwar trend of productivity growth. Estimates of potential output may be calculated by more or less sophisticated techniques. However, alternative estimates of potential output made by the Economic Council, using both simple and fairly complex methods of estimation, fall within a quite narrow range.

In the United States, "full employment" has usually been officially regarded, for practical purposes, as roughly 96 per cent of the labour force employed, implying a target rate of unemployment of about 4 per cent. Through much of the 1960's, this was denoted as an "interim" goal by the Council of Economic Advisers; in some U.S. quarters, a target of 3 per cent was used as a basis for calculating medium- or longer-term potentials. The Council of Economic Advisers currently defines potential output as the output that the U.S. economy would produce when operating at a 3.8 per cent unemployment rate, and has used this as a basis for calculating potential output estimates for past years. Thus, for the historical comparisons with the United States presented in Chart 5, we have calculated Canadian potential on the basis of a 3.8 per cent rate of unemployment.

CHART 5
POTENTIAL AND ACTUAL GROSS NATIONAL PRODUCT
CANADA AND UNITED STATES
(Billions of 1967 dollars)



*Estimates of actual Gross National Product in Canada and the United States for 1970 are from the Budget Speech of the Minister of Finance, March 12, 1970, and from the 1970 Annual Report of the U.S. Council of Economic Advisers, respectively.

Source: Based on data from Dominion Bureau of Statistics, U.S. Department of Commerce, and U.S. Council of Economic Advisers, and estimates by Economic Council of Canada.

Chart 5 shows that the potential Canadian growth *rate*—indicated by the slope of the potential output line—over the past decade and a half has been considerably greater than that of the United States. This is entirely due to the more rapid rate of labour force growth in Canada. In fact, the percentage increase in the labour force between 1956 and 1969 was about twice as high in Canada as in the United

States—41 per cent versus 21 per cent. In both countries, the growth of actual output in relation to potential has been quite uneven. The actual growth rate was well below the potential growth rate between 1956 and 1961. The opposite was true from 1961 to 1966.

By 1966, the *level* of actual output was above the level of estimated potential output in Canada, but since then, actual output has remained slightly below potential. In contrast, the United States remained at or above its potential *level* for the four years 1966-69, and only during the past few quarters has actual output fallen slightly below potential.

The Council of Economic Advisers has recommended that actual output in the United States should be held slightly below potential in 1970-71, and that in order to "slow down inflation", this gap should not be allowed to close until the latter part of 1972. This so-called "game plan" for the U.S. economy has significant implications for the prospective performance of the Canadian economy: on the one hand, if it is successful in slowing inflation in the United States, it will provide a more favourable external environment for achieving reasonable price stability in Canada; on the other, the maintenance of a significant gap between actual and potential output in the United States over the next couple of years implies less-expansionary external conditions for Canadian economic growth than those generally prevailing over the latter half of the 1960's.

The *level* of actual output in Canada was about 1½ per cent below the estimated *level* of potential output in the three years 1967-69 inclusive. Any shortfall from an actual annual growth *rate* of about 5¼ per cent would widen this gap. The latest official forecast for 1970 suggests that real output this year will be about 3 per cent above 1969. This implies an increase in the size of the gap to close to 4 per cent of potential in 1970—in other words, actual GNP would be about $3 billion below potential GNP (in 1970 dollars). This is a measure of the gap between actual output and the output which would have been produced if unemployment had been 3.8 per cent, and if productivity had been on its postwar trend.

The present shortfall of actual Canadian output below what we believe to be a reasonable—if anything, a rather conservative—estimate of its potential is therefore significant. Any widening of the gap would have, as one of its most visible features, rising unemployment.

Changes in the rate of unemployment are, of course, only one element in this gap. Also important are tendencies, though apparently with varying lags as such a gap tends to widen, for the labour force to grow less rapidly (partly resulting from some withdrawals from the labour force as jobs become harder to find) and for hours of work to decline (partly resulting from a relative shift to more part-time employment). Moreover, there is a further very important element—a widening gap between actual and potential output tends to be associated with deceleration in the rate of productivity advance, and a narrowing gap with acceleration. Between 1956 and 1961, when the gap was widening, Canadian real output per employed person grew at 1.3 per cent per year; from 1961 to 1966, when the gap was closing, the rate of real output growth per employed person rose at a rate of 3.1 per cent per year; and from 1966 to 1969, when the gap was widening again, the growth of real output per employed person fell back to 1.6 per cent per year. During periods of well-below-potential operation, capital formation also grows much more slowly or actually declines. Thus, from 1956 to 1961, business gross fixed capital formation (excluding residential construction) in constant dollars declined by 1.9 per cent per year; from 1961 to 1966, it rose by 12.0 per cent per year; and between 1966 and 1969, it declined again by 0.8 per cent per year.

Employment and Unemployment

Almost 1.9 million more Canadians are now employed than a decade ago—an increase of close to 30 per cent. This is substantially higher than the rate of employment growth experienced in any other industrial nation in the 1960's. This growth, in turn, is mainly due to Canada's huge postwar baby boom which has led to an upsurge in the numbers of young people moving into the labour force in the 1960's; but high immigration has also been a significant contributing factor. Reduced unemployment has not been a significant element in this great employment growth. While unemployment in Canada was very high a decade ago—7 per cent in 1960—and while reduced unemployment was a significant factor in the employment growth which accompanied the strong economic expansion through the mid-1960's, unemployment is now back to a rate not far below that of 1960.

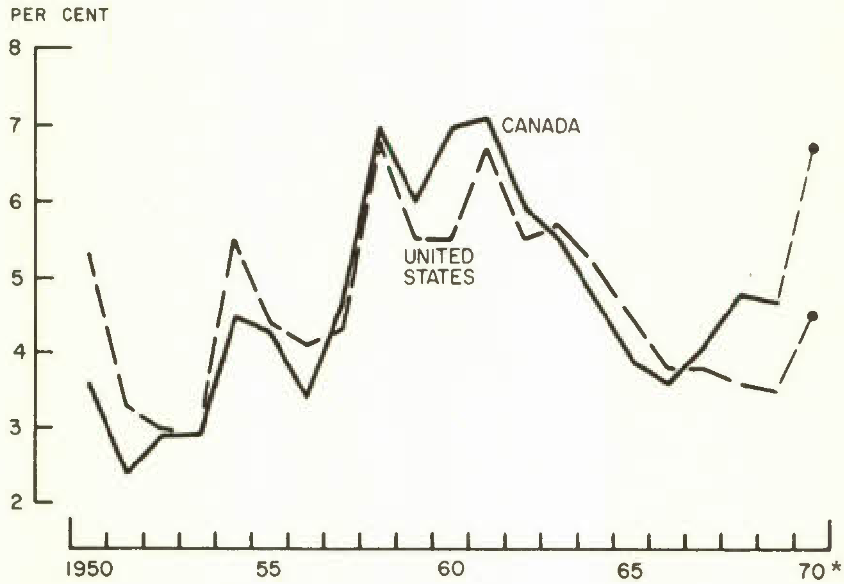
Unemployment has risen rapidly in 1970 to about 6½ per cent by mid-year, from the already relatively high average level of close to 5 per cent in the two preceding years. Moreover, the greatly enlarged manpower training and retraining programs developed over the past few years have been a factor tending to keep this rate from rising higher. In other words, they reduce measured unemployment as compared with earlier figures.

We regard recent and current rates of unemployment as unacceptably high. Canada probably now has the highest rate of unemployment among the more industrially advanced nations, even after allowance for the differences in the bases for unemployment estimates. The current rate is about double the medium-term target for Canada suggested in our *Sixth Annual Review.* The building up of unemployment to such high levels reflects a very considerable enlargement of burdens and hardships imposed on individuals and families. It also reflects a considerable waste of human resources and a large economic cost to the whole society. Reducing this high level of unemployment must therefore be considered—in human, social and economic terms—as a matter of the highest priority.

In the past three years, the unemployment rate in Canada has been significantly above that of the United States—on average, about $1\frac{1}{2}$ percentage points higher (Chart 6). In about half the years since 1950, the Canadian rate has been below the U.S. rate. The Canadian rate has usually been lower in prosperous periods, but higher in slack periods such as 1957-62. The fact that the unemployment rate was considerably higher in Canada in 1968-69, when the U.S. economy was being pressed hard against potential, is therefore an unusual pattern. It reflects, in part, the relatively stronger demand forces in operation in the United States and the relatively more vigorous demand restraints in Canada discussed below.

As unemployment has risen, and labour markets have become generally softer, employment growth has also slowed markedly. In 1970, the net additional jobs created have been only about one-third of the average of the preceding six years (see the bottom panel of Chart 7). This slowing of employment growth is characteristic of periods of emerging slack; a similar pattern occurred in 1957-61. Historically, still another feature of the labour force has emerged in such periods—the added numbers of people seeking work (the net additions to the labour force) have tended to fall increasingly below the added numbers of people of working age (the additions to population of 14 years of age and over). As shown in the upper panel of Chart 7, for example, the additions to the population of working age have been fairly consistently around 375,000 a year over the past five years. But the additions to the labour force have declined irregularly from around 275,000 in 1966-67 to less than 200,000 in the latest year-over-year comparison. In other words, when slack develops, participation in the labour force may be adversely affected, reflecting a combination of accentuated withdrawals from it and deferred entries into it.

CHART 6
ANNUAL AVERAGE RATES OF UNEMPLOYMENT
CANADA AND UNITED STATES



*Figures for 1970 are averages of seasonally adjusted data for June and July.
Source: Based on data from Dominion Bureau of Statistics and U.S. Department of Labor.

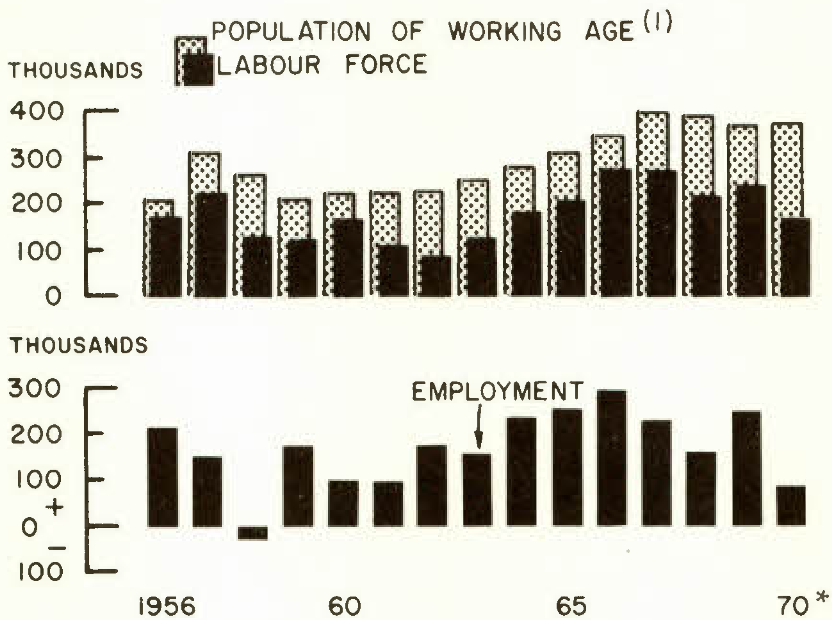
Prices and Costs

Large and persistent increases in general levels of prices and costs constituted one of the most serious shortfalls from good performance in the Canadian economy over the last half of the 1960's. Such increases continue to be relatively high and widespread in 1970, although some moderation in the advances of certain general price measures appears to be emerging.

A comparison of the percentage increases recorded by the Canadian and U.S. GNP price indexes over the years 1956-70 is shown in

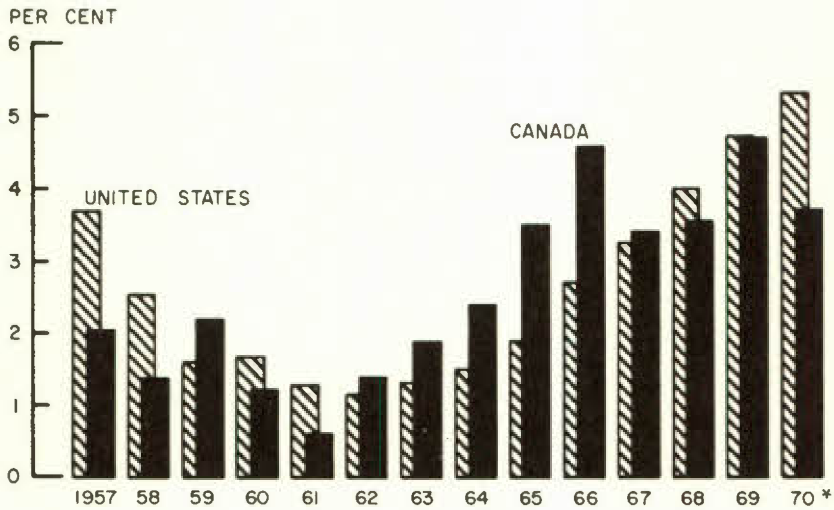
Chart 8. In broad terms, the behaviour of these indexes can be linked to the patterns of actual and potential output shown in Chart 5. At the beginning of the period, in 1956-57, price pressures were strong in both countries but the widening gap between actual and potential output and the growing underutilization of labour and capital over the next few years gradually exerted downward pressure on the rates of price increase. As the gap between actual and potential output began to close again after 1961, price increases became somewhat larger, although still moderate. By the mid-1960's, however, when actual output was continuing to rise very strongly and approaching potential, prices rose rapidly. Many factors appear to have been involved in this acceleration of price increases, as well as in the subsequent continued high rates of increase over recent years.

CHART 7
INCREASES IN SELECTED LABOUR FORCE MEASURES
(Year-over-year)



*1969-70 changes are from averages for first seven months of 1969 and 1970.
[1]Civilian, noninstitutional population 14 years of age and over.
Source: Based on data from Dominion Bureau of Statistics.

CHART 8
PRICE COMPONENT IN GROSS NATIONAL PRODUCT
CANADA AND UNITED STATES
(Year-over-year)



*Increases for 1970 are changes between second quarter of 1969 and second quarter of 1970.

Source: Based on data from Dominion Bureau of Statistics and U.S. Department of Commerce.

There were, nonetheless, significant differences between the Canadian and U.S. price performances. Between 1960 and 1962, the exchange value of the Canadian dollar was reduced by about 13 per cent and finally pegged at 92.5 U.S. cents. This devaluation tended to raise Canadian prices of imported goods and also the price "ceilings" of domestically produced goods subject to foreign competition. It was also possible to reduce certain Canadian export prices in terms of foreign currencies. The stimulus to Canadian production resulting from accentuated exports and constrained imports was a welcome development in the slack conditions of the early 1960's. Although a broad range of prices rose moderately in 1962-64, with widespread effects upon the entire structure of Canadian prices and costs, the increased call upon Canadian production could be readily accommodated without excessive demand pressures being generated. As the North American economy approached potential output in the mid-1960's, however, strongly rising demand began to press hard on available resources. In Canada, a combination of strongly rising demands was in evidence—a business investment boom, accelerated increases in government spending, strong advances in exports in general and in such categories as wheat in particular, the impact of the Automotive Agreement with the United States, and the build-up of facilities for Canada's centennial celebrations and Expo 67. In these circumstances, the extra demand that devaluation had tended to induce reinforced the direct price effects of devaluation in generating higher rates of price increase in Canada than in the United States.

After 1966, the level of actual output exceeded the level of potential output in the United States, although not in Canada. The small degree of emerging slack in Canada tended to moderate the rates of increase in Canadian prices vis-à-vis those in the United States to some degree, but Canadian prices and costs nonetheless increased strongly along with those in the United States during the rapid expansion following the brief 1966-67 slowdown. As Chart 8 shows, the increase in the price component of Gross National Product was about the same in Canada and the United States in 1967. The rates of price and cost increase since then are shown in Table 1.

TABLE 1

PRICE AND COST INCREASES, CANADA AND UNITED STATES
(From 1967 to second quarter 1970)

	Canada	United States
GNP Price Index	12·2	13·9
Consumer Price Index	12·4	15·8
Wholesale Price Index	9·0	10·1
Wage and salary costs per unit of Real GNP	16·5	19·2

SOURCE: Based on data from Dominion Bureau of Statistics and U.S. Department of Commerce.

Imports from the United States—which account for over 70 per cent of total Canadian goods imports—constitute one of the most clearly visible links through which U.S. price and cost developments are transmitted to the Canadian economy. Most of Canada's machinery imports are from the United States and the cost of capital goods in Canada is therefore highly sensitive to U.S. price movements. Similarly, when markets are buoyant in the United States and prices are rising, many Canadian export prices rise roughly in step with many U.S. prices. The influence of the U.S. goods prices is not confined merely to the export and import sectors. In the markets for many of the goods produced in Canada which face the threat of U.S. competition but are protected by tariffs, there is a tendency for Canadian maufacturers to establish prices a little below the U.S. price for the commodity plus the tariff. A rise in U.S. prices permits these producers to raise their prices without added risks of exposure to U.S. competition.

A further common influence on price levels in the two countries is the level of interest rates, which is an important factor in the total costs of more capital-intensive activities, including housing. The rising costs of housing and of rental accommodation in recent years has been a major contributor to the rise in the Consumer Price Index, in turn leading to escalating wage demands. And still other common influences emerge from a variety of close industrial, labour and other links between Canada and the United States—links which, among other things, tend to induce similar attitudes and expectations on both sides of the border.

In a free-bargaining situation, with strikes as the ultimate weapon, employers' resistance to wage demands depends to a critical extent on their own market conditions and prospects. If they are heavily export-oriented, restraint on domestic expenditures may not exert a crucial influence on their bargaining posture. Disruption of profitable production for export may be too high a price to pay for the smaller increases in wage costs which might be secured through intensive bargaining; in any event, both psychologically and morally, such employers are in a weak position to refuse wage increases when product prices and profits are climbing. The workers receiving increases form part of the labour market in Canada, however, and influence attitudes and expectations regarding appropriate rates of increase throughout that market. The mobility of certain skilled and professional workers has possibly also been of some importance in maintaining similar rates of increase in wages and salaries in particular occupations in the two countries, with additional effects on the overall structure of wages.

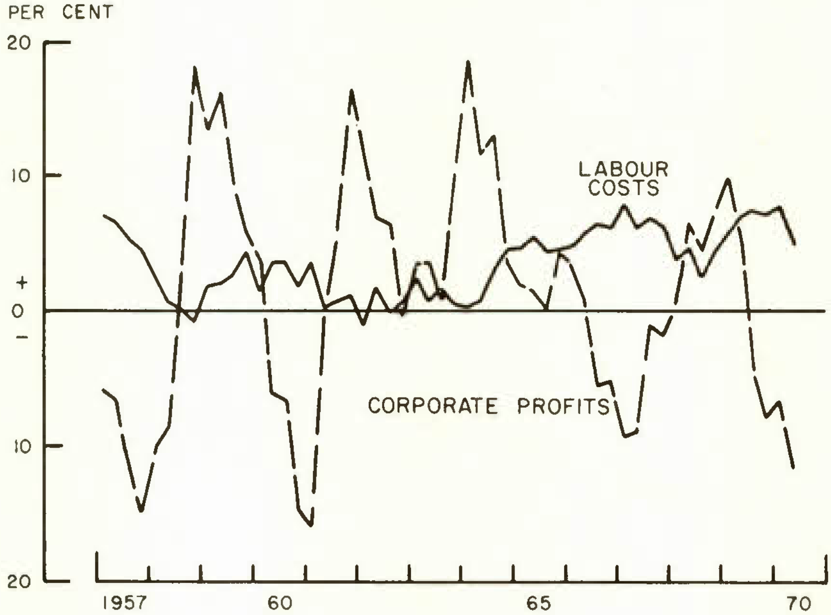
These and other direct and indirect effects of U.S. price increases upon the Canadian price level appear to have remained powerful in recent years. The recent adoption of more restrictive long-term policies aimed at curbing the rate of inflation in the United States promises to facilitate a marked improvement in future Canadian price behaviour. A factor in progress towards such performance is likely to be some moderation in the average increases negotiated in

Canadian and U.S. wage settlements, against the background of reduced profits, high unemployment, adjustments in inventory purchases, and curtailed capital expenditures. Such a sequence has been typical in the past. The see-sawing of unit profits and unit wage and salary costs is depicted in Chart 9.

CHART 9

CHANGES IN QUARTERLY ESTIMATES OF LABOUR COSTS AND CORPORATE PROFITS PER UNIT OF REAL GROSS NATIONAL PRODUCT

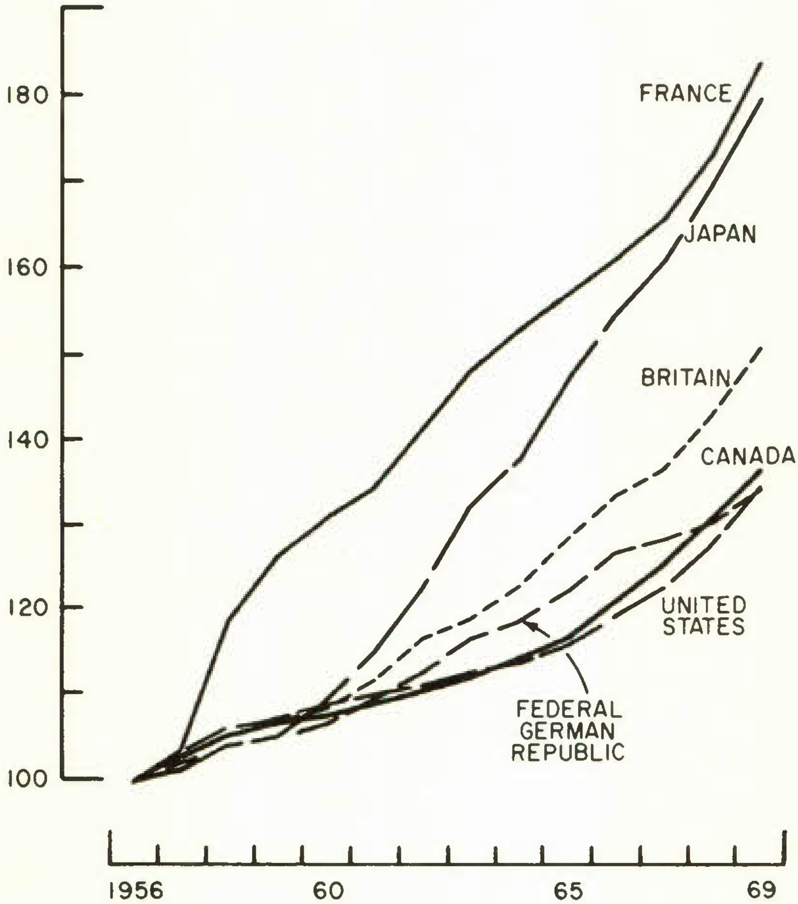
(Year-over-year)



Source: Based on data from Dominion Bureau of Statistics.

Canada and the United States have not, of course, been alone in experiencing inflationary pressures. Consumer prices, for example, have been rising considerably more rapidly in most of the major industrial countries overseas than in North America. Chart 10, which provides an international comparison of consumer-price behaviour over the 1956-69 period, shows that other industrial countries, with the important exception of the Federal German Republic, generally had faster price increases than Canada and the United States over this period as a whole.

CHART 10
CONSUMER PRICE INDEXES, SELECTED COUNTRIES
(1956 = 100)



Source: Based on data from Dominion Bureau of Statistics and U.S. Department of Commerce.

There has also been a sharp acceleration, on a worldwide basis, of prices of industrial goods moving in international trade in 1969 and 1970, after a very long period of relative stability in such prices. Canadian import prices in 1969, for example, rose at an annual rate of over 3 per cent—more than three times the average annual rate of increase over the preceding five years. Since a large proportion of these imports constitute inputs into production in Canada—for example, machinery and equipment, industrial materials, and component products—the result has been some accentuation of cost increases in Canada.

In addition to the external influences discussed above, there have also been many domestic influences tending to exert upward pressures on costs, and hence on prices. In some situations in Canada, reduced productivity gains—partly reflecting slower demand growth—have been a significant factor tending to raise labour costs and capital costs per unit of output.

Also, much attention has recently been focused in Canada (and elsewhere) on increases in money incomes—especially in wages, salaries, and professional fees—as a major factor contributing to sustained upward pressure on costs and prices. Of course, to state that increases in total money incomes in excess of increases in total real output will be reflected in higher prices is no more than a truism. But the factors that produce demands for larger increases in money incomes—increases that may be in excess of any possible increases in output or productivity—are not always fully recognized.

One element in this complex matter is the attempt to "catch up" with previous price increases or to offset anticipated price increases. In other words, "inflation" itself may tend to become a built-in factor tending to sustain, perhaps even to augment, further inflation (see below for a further discussion of expectations). Another element in the pressure for higher incomes—one that has tended to be underemphasized—may be increases in taxes.[1] Indirect tax revenues (sales, excise and property taxes, and customs duties) increased by about 10 per cent a year in the latter part of the 1960's (Table 2), partly as a result of increased tax rates and partly as a result of increased business volume. Moreover, in recent years, partly reflecting increases in tax rates, there have been very substantial increases in income tax collections. For example, between 1965 and 1969, total revenues from direct personal taxes rose at an average annual rate of over 22 per cent. As shown in Chart 11, personal income at the end of the 1960's was about two and a half times the level of the mid-1950's, while personal income taxes and employer and employee contributions

[1] In this context, two important points deserve emphasis. First, some taxes, such as sales taxes and property taxes, are included in some of the measures used as indicators of inflation, such as the Consumer Price Index; in other words, increases in such taxes tend to show up immediately as elements of price increases. Second, increases in taxes may not only have "income-push" effects but also constraining effects on the expansion of private demand, and the latter will tend to curtail price increases.

to insurance and pension plans were about five times as high.[1] More recently, these disparities have been even more marked: in 1965-69, personal income increased by about 50 per cent, while personal income tax revenues and the pension and insurance contributions more than doubled. When these rapid increases in taxes and contributions are combined with the fact that consumer prices were also rising at more than double the rate of the earlier period, the pressure on individuals to maintain their *real after-tax income* positions has been very great, and there are signs that an increasing number of groups are taking not only price changes but also tax changes more explicitly into account in their approaches to income bargaining.

TABLE 2

INCREASES IN PERSONAL INCOME, DIRECT PERSONAL TAX REVENUES, AFTER-TAX REAL PERSONAL INCOME, AND INDIRECT TAX REVENUES

	1961-65	1965-69
	(Average annual percentage change)	
Personal income	8·4	10·9
Direct tax revenues—persons	10·7	22·6
Disposable (after-tax) income	8·1	9·0
Consumer Price Index	1·8	4·0
Disposable (after-tax) income adjusted for increase in CPI	6·2	4·8
Indirect tax revenues (sales, excise and property taxes, and customs duties)	10·7	10·0

SOURCE: Based on data from Dominion Bureau of Statistics.

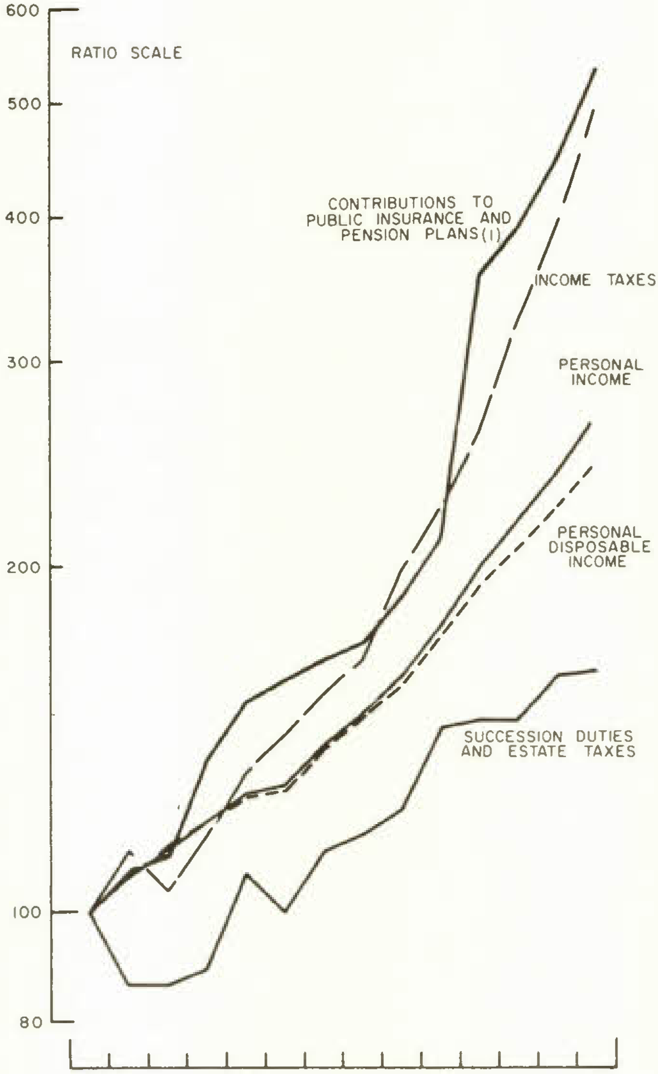
Two additional factors behind the information in Table 2 should be emphasized. The first is that a very significant part of the increase in the Consumer Price Index that has been occurring over the past year or two—up to 30 per cent—has reflected the rising cost of shelter. A combination of relatively low housing-vacancy rates in some cities,

[1] Over one-fifth of the overall increase from 1956 to 1969 in total revenues from direct personal taxes and pension, insurance and other contributions, as shown in Chart 11, appears to have resulted from increased tax rates (by both federal and provincial governments) and the introduction of the Canada and Quebec Pension Plans; and close to four-fifths of the total increase in such revenues is estimated to be the "fiscal dividend" accruing to federal and provincial governments from the application of the 1956 levels of tax rates to rising taxable incomes.

CHART 11

PERSONAL INCOME, PERSONAL DISPOSABLE INCOME, INSURANCE AND PENSION CONTRIBUTIONS, AND TAX REVENUES

(1956 = 100)



[1]Includes contributions to Canada and Quebec Pension Plans, Unemployment Insurance Fund, Workmen's Compensation Funds, and medical and hospital insurance plans; a number of miscellaneous licences and fees are also included.

Source: Based on data from Dominion Bureau of Statistics.

rapidly increasing land costs, higher building costs, and extraordinarily high levels of mortgage interest rates, have produced exceptionally strong cost and price pressures in this sector, both for rents and for home ownership and maintenance costs. These, in turn, have contributed to the sustained upward pressure for higher incomes.

Second, it should be borne in mind that rising tax revenues in this period have been partly matched by a rising amount of "collective consumption"—especially in such areas as health services, education, and roads and highways—and by increases in social insurance benefits. In other words, individuals are benefiting collectively from services paid for by rising tax revenues, for which they would otherwise be required to earmark a substantial portion of their incomes. Personal after-tax incomes must, under these circumstances, advance less rapidly.

A number of other factors from the "cost" side have undoubtedly contributed to the upward pressures on prices in recent years. Very high interest rates have added to the cost of financing capital investments. Strong increases in costs and prices in the construction industry have directly raised costs in other sectors and, in addition, have had an indirect effect through their influence as "pattern-setters". And finally, structural changes in the economy, away from goods and towards service production and consumption, have been tending to add to price increases as a growing proportion of economic activity has been shifting into what are essentially cost-plus categories of price determination. Moreover, in general, in those sectors of the economy in which measured productivity increases are relatively small, measured price increases tend to be relatively large. This appears to be the situation for many service industries. In other words, in addition to whatever "cost-push" effects may arise from the more commonly emphasized use of "market power" by labour unions and business organizations operating in imperfectly working labour and product markets, there are similar effects arising in very rapidly growing service areas of the economy in which market forces are extremely weak or even absent altogether. And the relative growth in the size of these service activities means that they are having an increasingly large influence on overall price performance in the economy.

These dynamic forces, both external and internal, tending to bring about increases in incomes, costs and prices, can be very powerful in the short run. But in the longer run they are substantially influenced by total demand changes and therefore (though usually with considerable lags) by the principal demand-management policies—monetary and fiscal policy. This is a subject to which we return later.

The Balance of Payments

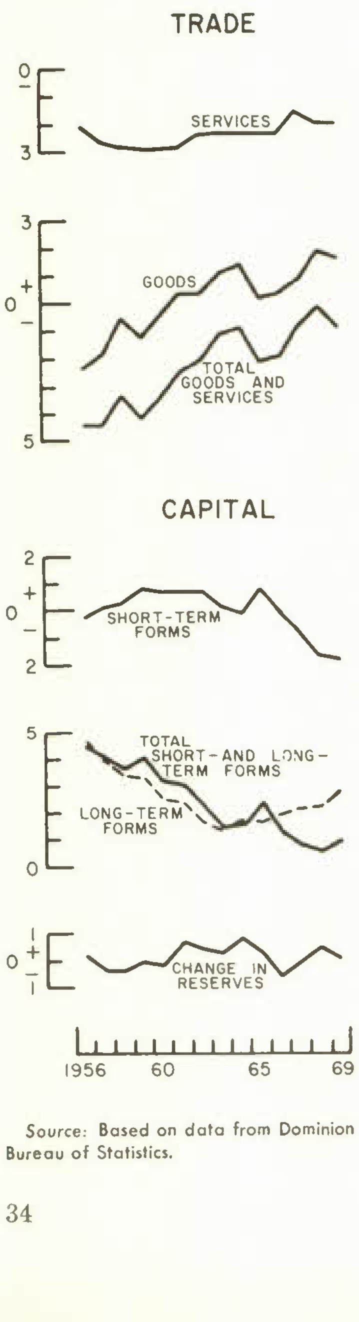
The economic basis for viability of the balance of payments has been relatively strong in recent years. The current account deficit for international transactions in goods and services was reduced from an annual average of more than $1.3 billion in 1956-60 to an average of less than $0.5 billion in 1967-69. Though there were runs on the Canadian dollar that forced Canada to obtain international financial support in 1962 and 1968, ordinary capital inflows were generally adequate to cover the annual deficits and to augment domestic investment resources.

From the 1950's to the 1960's the goods balance swung from a large deficit (averaging over $650 million in 1956-57) to a large surplus (averaging over $1.1 billion in 1968-69). The deficit on service transactions, such as interest, dividends, tourism and business services, increased steadily from less than $650 million in 1956 to almost $1.6 billion in 1969.

These developments can be placed in better perspective by relating them to the growing size of the Canadian economy. From the mid-1950's to the end of the 1960's, the current account deficit (and the net capital inflow) declined from close to 5 per cent of GNP to about 1 per cent (Chart 12). Changes in the merchandise trade balance mainly accounted for the large relative decline in the current account balance; the trade balance shifted from a deficit equivalent to 2 per cent of GNP in the mid-1950's to a surplus equivalent of about 2 per cent of GNP by the end of the 1960's. Apart from 1967, the services deficit remained in a range of 2 to 3 per cent of GNP (Chart 12). Over this period, net inflows of capital in long-term forms—such as direct investment, net new issues of Canadian bonds to non-residents, trade in outstanding securities and export credits—decreased significantly in relation to output (from about 4 per cent of GNP in the mid-1950's to about 2 per cent in the latter part of the 1960's). In relative terms, such net inflows also declined significantly as a source of savings for investment in Canada. At the same time, continued access to foreign capital remained an important consideration for Canada. This access was maintained in the 1960's by securing exemptions from the U.S. Interest Equalization Tax and from U.S. direct controls on capital outflows.

CHART 12

NET TRADE AND CAPITAL FLOWS AS PERCENTAGE OF GROSS NATIONAL PRODUCT



Source: Based on data from Dominion Bureau of Statistics.

In 1956, when the economy was at potential, the large deficit in trade was associated with a strong inflow of long-term capital (especially in the form of direct investment and through borrowing abroad by Canadians, particularly in the United States). In the years 1957-61, imports of goods were depressed, as economic slack increased. Exports of goods rose moderately—by a billion dollars in this period—and the services deficit increased by half a billion. Capital inflows (apart from reserves) were relatively high (averaging about $1.3 billion annually), and the floating dollar remained at a premium in U.S. funds through the late 1950's and 1960.

In retrospect, it is clear that monetary policy was inappropriately restrictive in the late 1950's and that the Canadian economy did not adjust well to slow North American growth. More-expansive domestic policies at that time would have avoided needless slack and also would have moderated the high capital inflows.

Expansion after 1961 did not create the merchandise deficit that characterized previous periods of rapid growth. Exports outpaced imports of goods for many reasons. There were two big sales of wheat to Russia, but, on the other side, uranium exports declined. Policies for oil, defence production, export financing, and especially the Automotive Trade Agreement with the United States affected the level and balance of merchandise trade. Reduction in the exchange value of the Canadian dollar in 1961-62 reduced Canadian prices relative to foreign prices, retarding the growth of highly manufactured imports and stimulating exports over an extended period.

The most important factors in the persistently rising overall deficit for services have been the increased deficits in interest and dividend payments and on payments for business services. From 1956 to 1961, the total deficit on services rose at a faster rate than GNP, but subsequently it has risen at a slower rate.

During the high-growth period of the 1960's, capital imports amounted to a relatively low percentage of GNP. This was a basic feature of the export-led growth that characterized the last decade. It contrasts with the higher percentage of capital imports during the slow-growth period of 1956-61.

The investment boom of the early 1950's, which was heavily concentrated in the resource industries, expanded those export-oriented industries which had historically accounted for a substantial proportion of output in Canada as a whole, and an even higher proportion in particular regions. Export-oriented resource industries were also expanded during the 1960's, but a new dimension was added in the last decade in that the automotive industry and certain other industries manufacturing more highly processed products were encouraged to specialize for international markets in order to improve their productivity performance. Such specialization implies, of course, an expansion of *imports* as well as of exports. The case for seeking an export *surplus* of goods rests, at least as a practical matter, on the need to finance at least some portion of the persistently rising services deficit from current earnings of foreign exchange. This need in turn is related to the world scarcity of, and high interest rates on, capital. Canada will continue to require imports of foreign capital (and associated technology) in large amounts, but this country cannot assume that such supplies will be unlimited.

From early 1969 to early 1970, virtually all of the increase in real GNP went into expanded Canadian exports. The floating of the dollar in June 1970 is attributable to Canada's decision that it would not continue to finance a very rapidly increasing volume of exchange reserves at the previous fixed rate of exchange, especially in the light of the possibility of a massive speculative inflow of capital. The huge merchandise trade surplus (about $1.3 billion in the first half of

1970) and a strong capital inflow swiftly drained away the Canadian dollar balances of the Government of Canada that were required for purchasing foreign exchange accumulating in the official reserves. Policies of restraint in Canada tended to slow the growth of imports and thus contributed to the increased trade surplus.

Since June, the Canadian dollar has appreciated. An appreciation of any significance, were it to remain, would tend to have two sets of effects. First, both directly and indirectly, it would tend to restrain price increases. Second, it would tend to constrain exports and encourage imports, and hence to reduce the merchandise trade surplus. This could tend to make the reduction of economic slack in Canada more difficult, unless offset by other factors. In the past, exchange rate changes (even when these changes were quite large) appear to have produced their maximum effects on prices and trade only with relatively long lags—of the order of two or three years or more. Nevertheless, at least the trade effects, especially the constraining effects on exports, could eventually be quite substantial if there were to be a considerable and lasting appreciation.

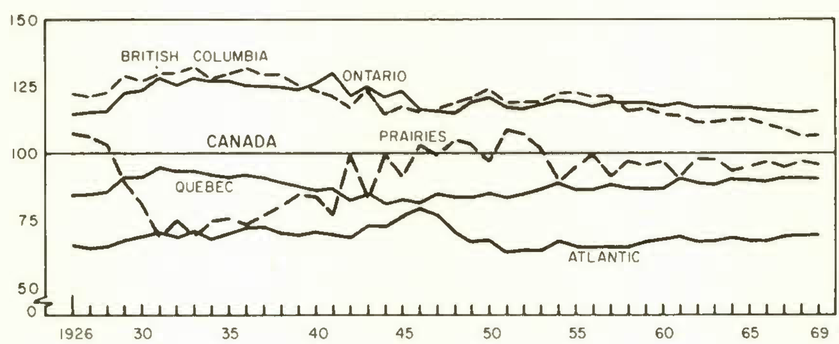
Whether Canada could maintain medium-and longer-term balance-of-payments viability with the Canadian dollar at a level which was close to par with the U.S. dollar is an open question—at least in the context of high-employment conditions. There are, of course, certain circumstances in which such a level of the exchange rate might be viable—for example, with a large rise in foreign demand for Canadian resource products, or with a large and sustained capital inflow. But under such conditions, the road to continued competitiveness for Canadian industries producing highly manufactured goods (both exporting and import-competing industries) would be a more difficult one than in the 1960's. Another set of circumstances in which a relatively high Canadian exchange rate could conceivably be maintained would be those in which consistent strong performance could be achieved in the international price competitiveness of Canadian producers of highly manufactured products. But in the latter as well as in the former circumstances, technological change and rising productivity in Canadian manufacturing would be even more important than in the past decade. The exchange rate is in fact a very important *price* in Canada's overall price system, and changes in it tend to have far-reaching consequences for many parts of the economy.

Regional Disparities and Poverty

In our *Fifth Annual Review* we defined the objective of improved regional balance to mean "both the narrowing of interregional income disparities and the full and efficient use of available resources in each region".

Large disparities in average levels of income among regions have been a long-run phenomenon in Canada (Chart 13). During the past two decades there has been some slight progress in narrowing them. In the last year or two, regional programs of the federal government, aimed at promoting progress towards better economic performance in low-income regions, have been expanded, even against the background of general federal expenditure restraints.

CHART 13
REGIONAL PERSONAL INCOME PER CAPITA
AS PERCENTAGE OF CANADIAN AVERAGE



Source: Based on data from Dominion Bureau of Statistics.

The emergence of some slack in the late 1960's and the development of more slack in 1970 is again being accompanied, as in earlier similar conditions, by the slower growth of employment and high unemployment rates in the lower-income regions. As shown in Table 3, employment growth in the Atlantic Provinces has averaged only 4,000 per year over the past three years (total employment in the Atlantic Provinces was 605,000 in 1969). Similarly, in this three-year period, employment growth in Quebec has averaged less than 20,000 per year (total employment in Quebec was over 2,130,000 in 1969).

As Chart 14 indicates, rates of unemployment have become very high in the Atlantic Provinces, Quebec and British Columbia, in all of which the unemployment rates tend to be relatively high when

TABLE 3

REGIONAL COMPOSITION OF CHANGES IN EMPLOYMENT OVER PREVIOUS YEAR

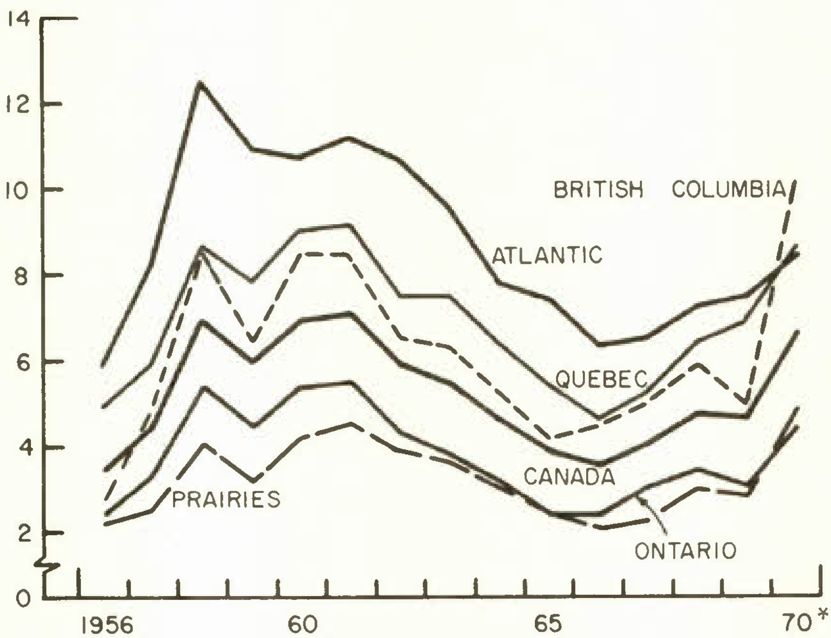
(Thousands of jobs)

Region	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Atlantic Provinces	3	−23	13	10	15	9	6	20	24	20	7	3	9	1
Quebec	41	6	38	19	13	61	49	65	85	104	64	2	50	3
Ontario	65	−19	56	51	20	48	65	91	75	103	94	85	106	49
Prairies	16	21	36	20	31	29	9	24	34	26	16	42	32	1
British Columbia	20	−8	20	−5	11	24	20	34	34	39	45	27	45	23
Total	145	−23	163	95	90	171	149	234	252	292	226	159	242	77

Note: Changes in employment in 1970 are derived from January-July averages for 1969 and 1970.
Source: Based on data from Dominion Bureau of Statistics.

slack develops in the Canadian economy generally. An unusual feature in the recent pattern of increases in unemployment rates is that the Prairie Provinces, which typically have a rate below that of Ontario, had a higher rate in mid-1970. This is a reflection of special difficulties associated with wheat and potash marketing and problems in the construction industry. Another unusual feature is the exceptionally high rate of unemployment in British Columbia in mid-1970. This reflects, in part, the effects on the regional economy of increased industrial disputes, and perhaps also a stepped-up flow of migration to this province.

CHART 14
REGIONAL UNEMPLOYMENT RATES
(Annual average percentage of labour force unemployed)



*Figures for 1970 are averages of seasonally adjusted data for June and July.
Source: Based on data from Dominion Bureau of Statistics.

As in the case of regional disparities, some progress was made in the 1950's and 1960's in reducing the overall incidence of poverty. In 1961, consumption patterns were examined to determine the income levels below which families spend 70 per cent or more of their income on food, clothing and shelter. These "poverty lines" have been adjusted for changes in the Consumer Price Index, and the data in Table 4 show the percentage of families and unattached individuals falling below these "poverty lines" expressed in constant (1961) dollars.

When slack is building up in the economy, the problems of many people in poverty tend to become intensified, although increased income support through unemployment insurance, welfare payments and other means may help to mitigate some of the problems. From 1957 to 1961, partly with the aid of such programs and also with substantial increases in old age pensions, the incidence of poverty continued to fall even though a substantial amount of slack emerged. More recently, with the re-emergence of some slack, the problems of the poor are again becoming accentuated, and again have been partly mitigated by the expansion of resources flowing to the poor through income-supporting programs. Unfortunately, no comprehensive data are available on the incidence of poverty beyond 1967.

TABLE 4

ESTIMATED INCIDENCE OF POVERTY, 1957-67

	Families	Unattached Individuals
Nonfarm	(Per cent of total)	
1957	31·3	49·8
1959	30·4	49·7
1961	25·9	48·8
1965	19·7	38·7
Nonfarm and farm		
1965	21·2	39·0
1967	18·6	39·0

SOURCE: Based on data from Dominion Bureau of Statistics.

A Summary

The Council's annual appraisals of the performance of the Canadian economy have been based on a careful monitoring of underlying economic trends and developments in order to detect forces and factors actually producing, or threatening to produce, major or prolonged departures from good performance and progress in relation to the goals and potentials with which our terms of reference require us to be concerned. At the risk of considerable oversimplification, the findings of our performance appraisals may be summarized as follows:

(1) On the whole, but with the glaring exception noted below, the performance of the economy since we started to make such appraisals in 1964 has been relatively good—certainly good in comparison with the generally poor performance in the late 1950's and early 1960's when the country experienced, in varying combinations, high unemployment, slow growth of average living standards, a bout of inflation, severe balance-of-payments strains, very substantial slack in low-income regions, and the emergence of serious economic imbalances that could not be quickly remedied. More recently, as the preceding discussion has indicated, the economy has been operating less favourably in relation to its basic economic and social goals.

(2) The glaring exception has been performance in relation to the goal of reasonable price stability. This has been a performance shortfall with which we have been persistently concerned over the latter part of the 1960's. Although some moderation in price increases may be emerging, performance in relation to the goal of reasonable price stability is still far from adequate; it is becoming clearer that the fundamental performance challenge here is, to some extent, international in scope, and of a long-run rather than short-run nature.

(3) Until last year, we were generally satisfied that the economy was moving towards or sustaining reasonably good performance in relation to the goal of full employment. Over a year ago, a slowing in the rate of growth of employment brought with it a rise in the rate of unemployment to close to 5 per cent. Since then, unemployment and economic slack have emerged on a scale that has opened a significant gap between actual and potential output.

(4) While the productivity growth rate was far from steady during the 1960's, a reasonably good productivity performance has been maintained over the decade, at least in relation to Canada's historical experience. One of our central concerns continues to be that of enlarging our understanding of factors influencing productivity growth, so that we can better advise on how to sustain and enhance it in the longer run.

(5) Although we have focused special attention, from time to time, on the need for maintaining international competitiveness and

adequate access to external sources of capital, we have concluded that Canada's balance-of-payments position has remained generally strong.

(6) With regard to the goal of an equitable distribution of rising incomes, we have noted that there was some reduction in poverty and some narrowing of regional economic disparities in the course of the 1960's. However, Canada continues to have very major poverty and regional disparity problems to which we have drawn special attention in various chapters of our Annual Reviews.

3

Demand Management

Among the most important of the decisions and policies that affect the performance of an economy are "demand-management" policies—monetary and fiscal policies. A review of some of the key concepts that can be used for evaluating such policies and of the main features of demand management in North America over the past decade might therefore be useful.

The level of total demand in an economy in relation to potential output plays a key role in the economy's performance. If demand is inadequate, actual output will fall below potential and the economy will experience economic slack or a recession. If, on the other hand, total demand is excessive, output will tend to be pushed above potential; the performance of the economy will be marred by price and cost instabilities and perhaps by balance-of-payments strains, as well as by various other imbalances, distortions and inequities.

The importance of demand-management policies lies in the role they can play in increasing, sustaining or reducing total demand in the economy. It is widely accepted that an "easy money policy" can permit or stimulate growth of total demand and that "tight money" can restrain it—and also that an "easy fiscal policy" can support demand expansion and that "fiscal restraint" can curb it. But, in this context, what is "easy" and what is "tight"? Unfortunately, there are no simple, neat and universally accepted answers to this question. But a great deal of attention and thought has been devoted to it, especially over the past decade, as well as to the related, and even more difficult, question of how shifts from "easy" to "tight" policies (or vice versa) influence the economic system.

In the case of monetary policy, there has been a growing tendency over recent years among experts to focus attention on variations in the growth rate of the supply of money (sometimes also on certain closely related variables) as one of the most useful indicators of easy or tight policies. There has been growing evidence to indicate that such variations exert a strong influence on subsequent changes in incomes, demand, output, and employment. There are, of course, a variety of ways in which a nation's money supply may be defined and measured. These and other complications have posed significant difficulties for using money-supply measures as the central basis for monetary policy decisions. Moreover, while central banks have powerful instruments through which they can bring about variations in the money supply, as a practical matter precise, predetermined changes are virtually impossible to achieve. There is an immense variety of factors influencing the components and use of a nation's money supply as a result of volatile activities in modern, complex, internationally interconnected, and highly elastic financial systems. Nevertheless, we believe that among the most useful (although still partial) measures of the degree of monetary restraint or ease are the broad variations of national money supplies. In the following analysis of Canadian and U.S. demand management through monetary policy, we therefore focus attention on the main changes in their respective money supplies over the 1960's.

In the case of fiscal policy, too, there are many complications in assessing its effects on demand. For instance, there is a wide variety of ways in which changing government expenditures, tax rates, tax structures, and debt management operations may affect demand that cannot all be readily encompassed in simple total measures. Also there are many ways in which government budgetary items may affect private spending (sometimes very significantly, and without major shifts in government budgets themselves). Perhaps in due course more comprehensive and sophisticated measures of fiscal policy may come into more general use. But in the present "state of the art" of fiscal policy appraisal, attention is usually focused, at least initially, on the *fiscal balance*—the deficit or surplus in government accounts (that is, the margin by which revenues fall short of, or exceed, expenditures). On this basis, it has become a part of the conventional wisdom that deficits tend to have expansionary effects on total demand and that surpluses tend to constrain total demand.

Yet discussions of fiscal policy in Canada and appraisals of its impact on the economy are frequently distorted, and sometimes misleading, owing to the use of partial and incomplete information, and to difficulties in interpreting the available information. Among the considerations frequently limiting assessments of fiscal policy are:

— the use of the federal government accounts only, leaving out of account the fiscal position of the provinces and the municipalities (a particularly important matter in Canada, since the combined budgets of provincial and municipal governments are now considerably larger than the budget of the federal government; the former also now have considerably greater access to growth-related tax sources than in earlier years);

— the use of the administrative accounts of government (the accounts which are the focus of attention in the budget speeches of Ministers of Finance and Treasurers), which were designed for budgetary control purposes and not for the broad assessment of economic effects;

— the failure to take into account the transactions of the Canada and Quebec Pension Plans, which are now generating revenues well in excess of pension outlays; and

— the use of "actual" deficits or surpluses as measures of fiscal stimulus or restraint, without regard to the prevailing level of economic activity (fiscal policy both affects and is affected by demand; for example, when slack exists, government revenues are depressed, and budgetary deficits may simply reflect low levels of economic activity rather than a fundamentally expansionary fiscal policy).

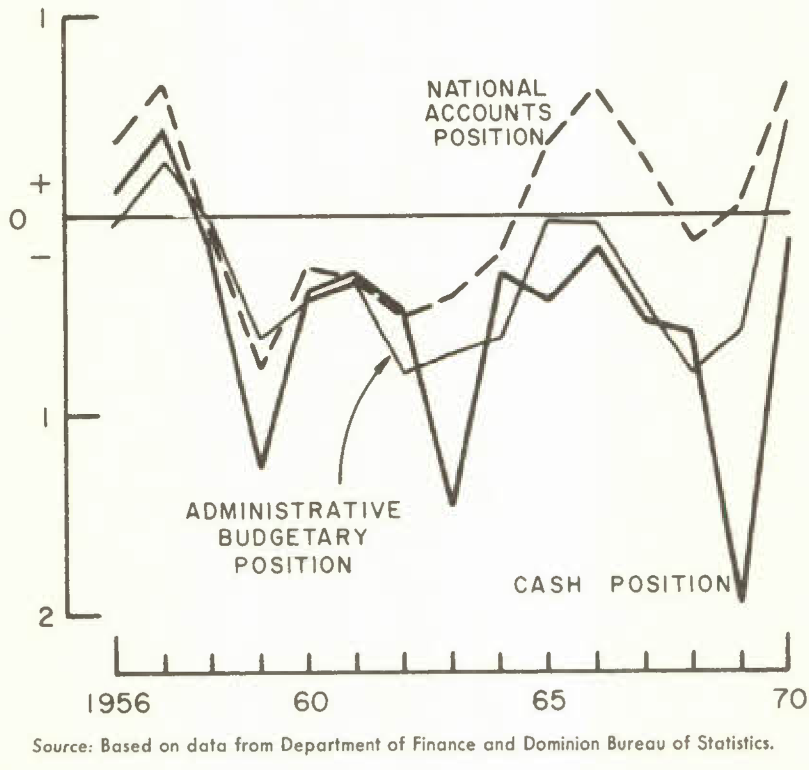
In brief, if budgetary deficits and surpluses are to be used as measures of fiscal "ease" or fiscal "restraint", the central question is "*What deficits or surpluses?*" We believe that the most useful presentation for assessing fiscal impact is the national accounts budget and, more specifically, what can be called the *high-employment budget position* on a national accounts basis. The catch is that several different accounting presentations can be (and are) used to describe government operations. Each is designed for a particular purpose and can, in fact, be misleading if used for some other purpose.

Three Budget Concepts and Their Limitations

By way of illustrating some of the options available, let us consider for a moment the federal government position alone. Chart 15 shows the budgetary balance of the federal government on three different accounting bases—the administrative, cash, and national accounts presentations. We will return to the high employment version of the latter shortly.

Each of these budgetary concepts suggests quite different readings of fiscal ease or restraint for different years. For example, in most years in the middle or late 1960's, the administrative and cash budgets were in deficit when there was a surplus balance on the national accounts basis.

CHART 15
THREE ALTERNATIVE PRESENTATIONS
OF THE FEDERAL BUDGET POSITION,
FISCAL YEARS ENDING MARCH 31
(Billions of dollars)



Source: Based on data from Department of Finance and Dominion Bureau of Statistics.

What is perhaps most frequently referred to as the "budgetary position" is the balance in the administrative budget. This presentation, which is the central feature of the annual Budget Speech of the Minister of Finance, is designed essentially for administrative and control purposes. But it does not cover the transactions of some very important government funds, notably those for old age security, unemployment insurance and government trust and pension funds; nor does it include the very substantial loans and advances to the private sector. On the other hand, it does include a number of internal bookkeeping transactions, such as appropriations to special funds, which do not represent flows between the government and the private sector.

The statement of government cash transactions is more comprehensive than the administrative budget since it includes the net effects of government borrowing and lending operations as well as changes in the trust and pension accounts that affect the government's cash position. It is useful for the government's own cash management and is of considerable relevance for financial analysis.

The national accounts presentation of the budget is, however, more explicitly designed to meet the needs of economic analysis. It takes a wider range of transactions into account than the administrative budget, and it excludes transactions of a purely internal bookkeeping nature. It does not, unfortunately, in its present form, cover the government's borrowing and lending operations (which largely explains the difference in levels of the cash and national accounts balances in Chart 15).[1] These can also have important indirect economic effects. But it does have another major advantage. For reasons outlined above, the position of all governments should be taken into account in appraising fiscal policy. The national accounts presentation has in fact been developed to encompass, on a comparable basis, the accounts of all governments in Canada within a broad accounting framework employing consistent definitions throughout. In other words, not only can the federal position be consolidated with that of provincial and municipal governments but the impact of government transactions can be tied in directly with other sectors of the economy. Neither of these things can be done with the administrative budget or the cash statement.

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[1] What is required for the future is a still more comprehensive presentation linking *both* revenue-expenditure and financial transactions within a framework suitable for economic analysis.

The High-Employment Budget

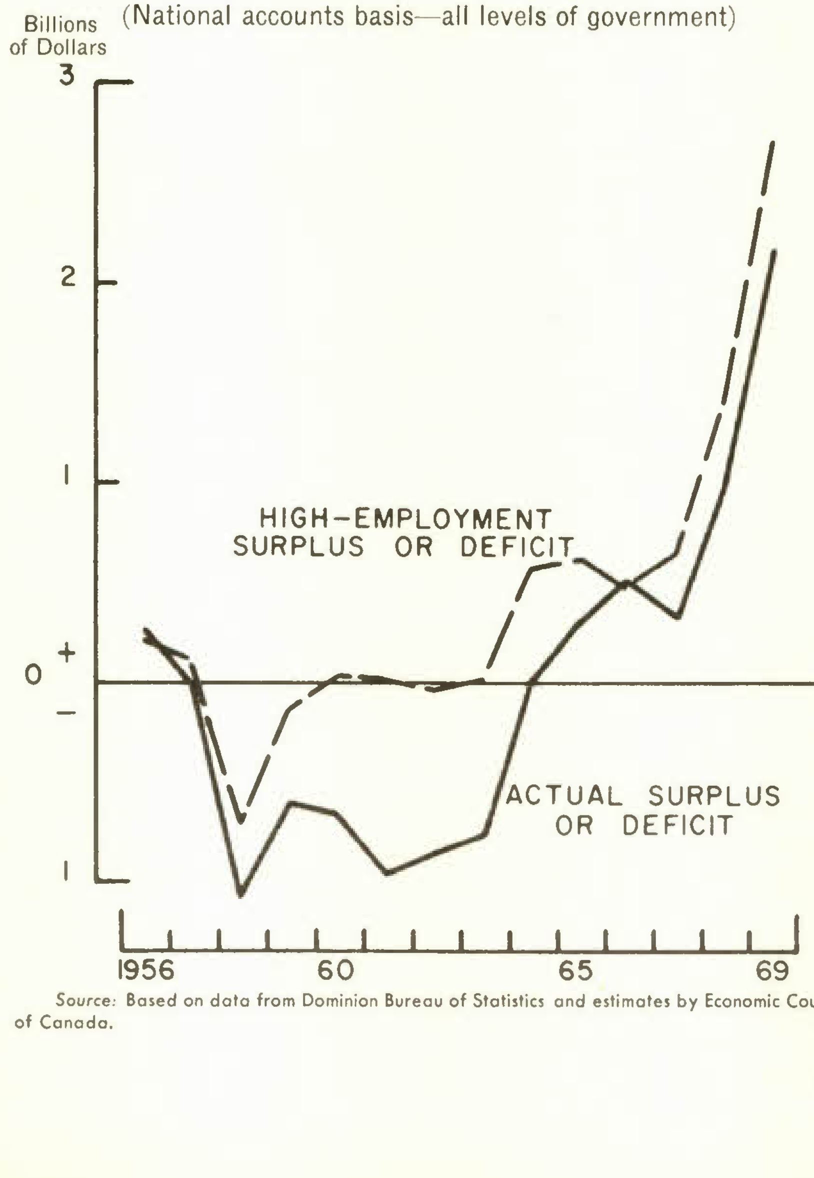
The recording of government transactions on a national accounts basis—something that has been done in federal Budget Speeches since 1964—is an essential and considerable step towards facilitating economic analysis of the budget. But there is still a problem. The actual budget surplus or deficit, even on a national accounts basis is the result of two sets of forces: the budget program (taxes and expenditures), and the strength of total demand in the economy. What we are interested in is how to attain full employment growth, and whether policy actions will move the economy towards, or away from, its potential growth path. In other words, we would like to distinguish the "direct" effect of policy actions from the "feedback" effects of other forces on the budgetary balance in the economy. To assist in this, and to provide a better basis for policy advice and decision-making, it is useful to have an estimate of what the fiscal balance would look like when the economy is operating at potential output, given *existing* tax rates and *existing* government expenditure programs.

Chart 16 illustrates the *actual* national accounts budget position (for all levels of government and including the Canada and Quebec Pension Plans) and the estimated high-employment budget position on a similar basis. The gap between these is a measure of the difference between what the fiscal balance actually *was*, and an estimate of what it *would have been* at potential output (given the existing tax rates and structure, and existing expenditure programs). Thus, when the economy was operating close to potential output, as in 1956-57 and 1965-67, there was little, if any, gap. On the other hand, in the early 1960's, when there was substantial slack in the economy, the gap was fairly large. This simply implies that, under these conditions, government revenues were considerably depressed by the relatively low levels of economic activity.

The implication of this chart is that the setting of fiscal policy cannot be judged with reference to the actual deficit or surplus position. The substantial actual deficits of the early 1960's essentially reflected the impact on the fiscal position of the large degree of economic slack, rather than an expansionary fiscal policy. A far more illuminating approach to the assessment of fiscal policy is to look at the fiscal position that would exist at high employment. On this basis, any significant surplus would represent a restraining posture—a posture tending to hold the economy below potential.

Conversely, any significant deficit on this basis would represent an expansionary posture—a posture tending to push the economy above potential. Thus, as indicated by the high-employment budget position shown in Chart 16, fiscal policy was expansionary in 1958 and highly restrictive in 1968-69.

CHART 16
HIGH-EMPLOYMENT FISCAL POSITION
AND ACTUAL FISCAL POSITION
(National accounts basis—all levels of government)



Source: Based on data from Dominion Bureau of Statistics and estimates by Economic Council of Canada.

We do not wish to oversimplify these matters. There are, of course, some imperfections in the use of high-employment budget measures as an indicator of policy settings.[1] But, in spite of these, this approach provides, in our judgment, the most useful basis for discussions of such settings.[2]

Monetary Policy

On the basis of the above-mentioned approach to appraising monetary policy settings by viewing broad changes in the nation's money supply, Chart 17 shows year-over-year changes in money supply in Canada and the United States since the latter part of the 1950's. Clearly evident from this chart are:

—the tight money policies at the end of the 1950's, just prior to the 1960-61 recession;

—the fairly stable increases in money supply over the early part of the 1960's;

—the considerable monetary expansion in the latter part of the 1960's (although there was a brief period of rapidly tightening restraint in 1966);[3] and

—the turn towards strong monetary restraint in 1968 and the persistence of such restraint through the early part of 1970.

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[1] In this context, Dr. Arthur Okun, a former Chairman of the U.S. Council of Economic Advisers, has recently stated:

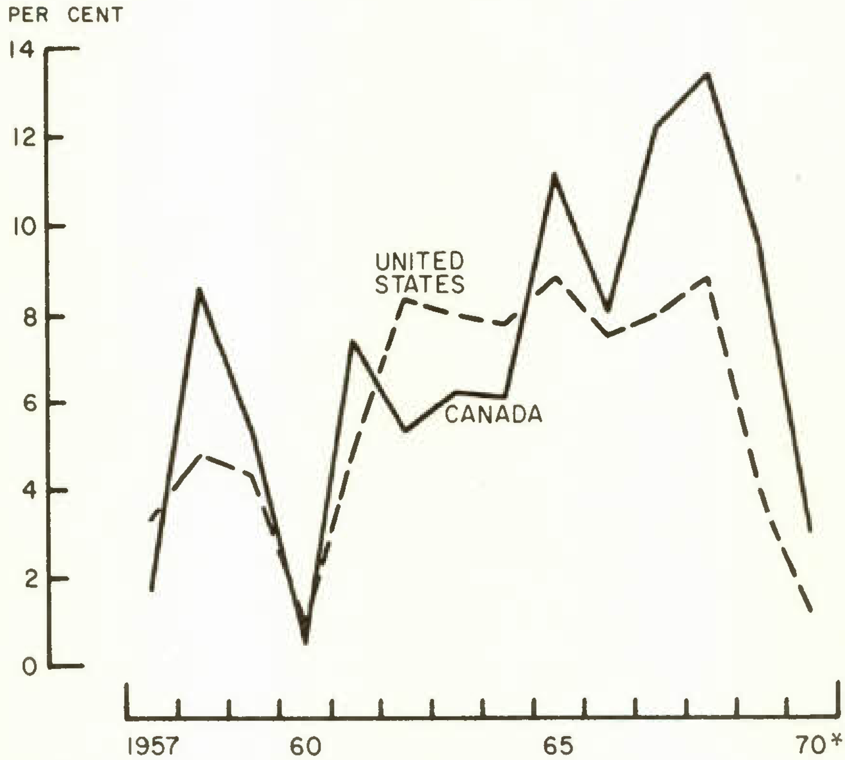
> As fiscal experts will recognize, the full employment surplus is an imperfect measure of budgetary impact. Three of its flaws are: (1) It sums and nets all types of expenditures and revenues as though they had equal bang-for-a-buck, which they don't; (2) it lags behind to the extent that government orders and contracts may influence private inventory investment (and employment demand) before they show up in the federal account; (3) it may show misleadingly large surpluses in a time of inflation if revenues respond more —and more promptly—to rising prices than do expenditures. We can adjust the full employment surplus for these to a degree, but we need better quantifications of fiscal impact. Still, for all its flaws, the full employment surplus is a shining jewel compared to the actual surplus (or deficit), which makes it appear that fiscal policy has shifted whenever a swing in private demand alters federal revenues.

The Political Economy of Prosperity, The Brookings Institution, Washington, D.C., 1970, p. 121.

[2] In any such discussions, two further important points need to be kept in mind. The first is that there are various important ways in which Canadian demand-management policies, particularly monetary policy, are influenced by general economic conditions and demand policy settings in the United States. The second is that there are important interconnections between monetary and fiscal policies, as well as between these and debt management policy, exchange policy and other policies.

[3] Some special factors were involved in the very high rates of monetary expansion indicated for Canada in 1967-68, including adjustments relating to changes in banking legislation.

CHART 17
CHANGES IN SUPPLY OF MONEY, CANADA AND UNITED STATES
(Year-over-year)



*First six months of 1970 over first six months of 1969.

Note: The supply of money is here defined as follows:
Canada—Currency outside banks and Canadian-dollar chartered bank deposits held by the general public.
United States—Currency plus demand deposits, plus time deposits of commercial and mutual savings banks.

Source: Bank of Canada and U.S. Federal Reserve Board.

Fiscal Policy

Chart 18 shows the high-employment budget position in both Canada and the United States for the period 1956-69.

Looking first at the U.S. fiscal conditions, it is evident that the high-employment fiscal position:

—remained generally somewhat restraining over most of the decade 1956-66, and was fairly strongly biased against the achievement of potential output through the early years of the 1960's when there was considerable slack in the economy;

—swung strongly towards an expansionary stimulus after the mid-1960's, following the major U.S. federal tax reductions of 1964 and the large rise in defence spending with increased military involvement in Vietnam; the latter was a significant factor tending to keep the U.S. economy operating with very strong total demand pressures above potential output in the late 1960's; and

—shifted back to a moderate degree of fiscal restraint following the major tax increases of 1968 and some curtailment of government spending; this was deliberately intended to bring the economy back below potential in the circumstances of strongly rising prices and costs.

The Canadian fiscal posture of all levels of government appears generally to have been more appropriate to the underlying economic conditions than that of the United States through much of the past decade (although we again emphasize that government borrowing and lending operations are not taken into account in these high-employment budget estimates, and that significant economic effects may result from such operations). The degree of fiscal restraint in Canada since 1968, however, has been very strong—much stronger than many Canadians have realized. In fact, in 1969, such restraint appeared to have been stronger than at any time since the Korean War in the early 1950's, when total demand was clearly excessive. Chart 18 indicates the following:

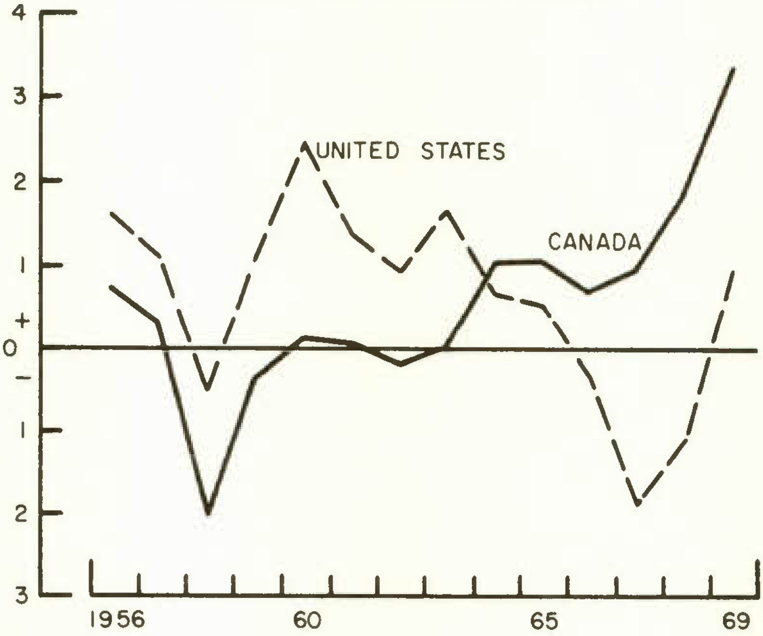
—under conditions of slack in the late 1950's and early 1960's the fiscal position was biased in favour of a return towards full employment, or at least not biased against it;

—in the mid-1960's, there was a modest high-employment surplus, when demand was rising strongly and inflationary price and cost dangers were intensifying; and

—more recently, there has been a very large high-employment surplus. In particular, in 1969, this fiscal position was one of substantial restraint, with a strong bias towards holding the economy below potential output. The building up of such fiscal restraint in 1968 and 1969 has been the result of a major shift in the combined budgetary positions of provincial and municipal governments, as well as that of the federal government.

CHART 18

ESTIMATED HIGH-EMPLOYMENT BUDGET SURPLUS OR DEFICIT AS PERCENTAGE OF POTENTIAL GROSS NATIONAL PRODUCT, ALL LEVELS OF GOVERNMENT, CANADA AND UNITED STATES



Note: High employment is defined for this purpose as the level of employment associated with 3.8 per cent unemployment. The high-employment budget position is calculated on a national accounts basis and is derived by estimating the change in revenues that would be realized at high employment—expenditures being assumed to remain unchanged.

Source: Based on data from Dominion Bureau of Statistics, U.S. Department of Commerce and U.S. Council of Economic Advisers, and estimates by Economic Council of Canda.

As will be indicated in more detail below, a further important consideration in the assessment of fiscal policy, as well as monetary policy, is that both of these policy instruments tend to produce their effects on total demand only with lags that are usually of considerable length.

During 1970, the previously heavy restraint settings of both monetary and fiscal policy have been eased. Monetary expansion was resumed, and was pronounced in the second quarter in the context of the large withdrawals from federal cash balances to purchase foreign exchange at a time of upward pressure on the Canadian exchange rate. Also, the degree of fiscal restraint has been somewhat reduced through decisions to enlarge certain expenditures.

4

Lessons of the 1960's

Before outlining some of the performance challenges for the 1970's and their implications for policy, it is useful to try to place in perspective some of the performance experience of the 1960's. We believe that in retrospect the 1960's will prove to have been a period in which some quite fundamental new insights were gained about the nature and requirements of good economic performance—insights that will, and should, influence planning and policy settings in both the public and private sectors in the 1970's. Out of the very wide variety of lessons that might be listed, we have chosen seven for emphasis.

Business Cycles

The prolonged recessionless expansion of the 1960's is a fact of considerable significance, for at no other time has the economy been free for a comparable period from recurrent bouts of recession and recovery. Only a decade ago, the business cycle represented a fundamental economic phenomenon, and the analysis of business cyclical indicators was a prominent field of economic research. Economic actions of governments were mainly directed to minimize these fluctuations which were thought to originate in decisions and activities in the private sector of the economy. Governments, in other words, tended to think of their role as a "balance wheel" in the economy, adding to total demand whenever private demand weakened, and constraining total demand whenever the latter became excessive. Subsequent analysis has suggested that sometimes the actions taken had destabilizing results. Compensatory measures were in practice not always appropriate in relation to the timing and amplitude of cyclical fluctuations. Lags in the system, and the difficulties involved in developing accurate forecasts sufficiently far ahead to provide an adequate basis for major policy changes, tend to make stabilization policies very difficult instruments to use effectively for offsetting short-term business fluctuations.

We have urged, because of these difficulties, that demand policies should be directed more to "steering the economy" along a smoother underlying growth path in final demand, in line with the economy's continually expanding potential. At the same time, we have also emphasized that, along with this, a wide range of complementary government and private policies are required for good performance—for example, in the fields of competition policy, mobility and training, adjustment assistance and productivity improvement. These views continue to shape our approach to the development of appropriate policy strategies for the future.

The Costs of Departing from Potential

Another major lesson of the 1960's was the demonstration of the very heavy costs incurred in failing to keep the economy at, or close to, its potential growth path. With a shortfall below potential output of about 7 or 8 per cent in 1961 in North America, the lost output in that year alone was equivalent to about $50 billion for the United States and over $3 billion for Canada (in today's larger Canadian economy, an equivalent gap would, of course, be bigger in dollar terms—over $5 billion). This was equivalent (for Canada in 1961) to substantially more than an entire year's production of new housing, or about one-half of all business spending on plant and equipment, or close to total personal spending on all durable goods. There was also a corresponding loss in incomes, reflected for example in lower average personal incomes and lower government revenues.

Moreover, such losses are cumulative for every year in which such a gap exists between actual and potential output. Nor is the loss ever made up, even when the gap is closed. Indeed, as we have already noted, such large losses may also tend to depress the future potentials of an economy for an extended period. In a society in which there is a vast and growing list of competing claims on the nation's limited resources—for health care, education, pollution control, urban development and a large array of other needs—we must aim to avoid such low levels of performance.

There are also costs that arise from pressing an economy too hard and too fast against its rising potential. Although these are very difficult to quantify, they are nevertheless real and important, and include such things as the disruption of financial markets (especially for fixed-income obligations), the erosion of savings, the inequities imposed on people on fixed and slowly rising incomes, the possible undermining of international competitive capabilities, and the diversion of greater energies and efforts to finding methods for escaping from the adverse consequences of inflation.

Imbalances and Lags

The past decade also demonstrated that once substantial imbalances develop in the economy, either because the economy is undershooting its potential growth path (as in 1957-61) or because of a prolonged period of growth above the potential *rate* (as in 1962-66), it takes much time and effort to get back on an appropriate growth path. No quick or easy solutions are available. Following the 1957-61 episode, which encompassed two recessions, it was not until 1964 that the unemployment rate in Canada moved back down to where it had been in 1957. And following the build-up of inflationary pressures by the mid-1960's, the sheer momentum of price and cost increases became one of the significant factors in the continuation of unacceptably high price and cost increases over the past few years in the face of some degree of slack.

The 1960's have also brought growing awareness of the long lags that frequently exist in the response of the economy to changes in policy aimed at influencing demand conditions.

In past Annual Reviews we have frequently referred to various types of lags that have made it particularly difficult to operate demand-management policies effectively. Three types of such lags are—"recognition" lags, or the time which elapses before statistical information becomes available and it is recognized that a change in the course of the economy is under way; "action" lags, or the time which elapses between the recognition of a change of course in the economy and the taking of some form of appropriate action; and the "impact" lags, or the time which elapses between the taking of compensatory action and the economy's response to this action. We are mainly concerned with this last lag in this section.

The economy's response to changes in fiscal and monetary policy is basically quite sluggish. We know much less than we need to know about the causes and lengths of these lags, about the impact of policy changes, and about the sequence through which they are reflected in changing patterns of income, output and demand. While many studies have sought to trace and identify these effects, the question of the impact and timing of monetary and fiscal policies is still a matter of some controversy. But there is general agreement on three points: lags exist; they are generally much longer than was believed at the beginning of the 1960's (though apparently variable, and hence difficult to predict); and they operate with a different time sequence on different parts of the economy.

In connection with this latter point, monetary restraints clearly impinge directly and immediately on the financial sector. However, the effects on real economic activity are felt only after some time. Typically, the first sectors to feel the impact are those that are closely related to financial markets—especially the housing sector, with its heavy dependence on mortgage financing. Here the impact of policy, especially restraining monetary policy, tends to be fairly quick and severe—frequently beginning within six months of restraint actions. The direct effects of restraint policies on business capital investment outlays do not appear to be large. In other words, it is the easing of demand pressures and not the restraint policies themselves that tends to bring about a business investment slowdown. Conversely, it appears to be the pressure of demand and not the direct effects of expansionary policies that triggers the revival of business investment spending. There is little evidence to suggest that business investment can be quickly stimulated once significant slack has developed in the economy and spending in this sector has become sluggish and depressed.

The problem of lags, in the context of the difficulties which they pose for stabilization policy, has been summed up in a simplified form in a comment by the Chairman of the Council of Economic Advisers in the United States:

> "Embedded in our strategy of policy also is a conviction that a substantial part of our instability historically has actually been caused by erratic movements in fiscal and monetary policies. The present inflation resulted from the overly expansive policies of 1967 and 1968, which were a reaction to the crunch of 1966, which was induced by the emergence of inflationary pressures because of overly easy policies in the latter half of 1965. We also take seriously the accumulating empirical evidence about the substantial lags before visible effects of a change of policies begin to show up in the economy. This all, therefore, suggests the desirability of trying for a more even-handed management of our fiscal and monetary policies—avoiding the wide swings to large deficits

> and back to significant surpluses, or the wide swings between credit crunches and inflationary rates of monetary and credit expansion. If we can get policies moving less erratically along a path basically consistent with high employment, we can hopefully at least reduce the instability that erratic policies have themselves introduced into the course of the economy. This does not, of course, mean less management of these policies. Indeed, it means a greater precision of management within a more explicitly delineated game plan."[1]

Also, of course, there are long lags in the operation of most *supply* policies. For example, the general levels of education in the labour force can only be raised significantly over a period of many years. Similarly, improvements in average work experience and in training and retraining programs, the development of new innovative capabilities and of higher levels of managerial competence, and increases in scale and specialization made possible by broader access to export markets, all take considerable time to achieve.[2] The very complexity of modern industrial activity—its increased scale and sophisticated technology—is responsible for substantial delays between the planning of activity and the production and marketing of the final product. Frequently, there are many intervening stages—research and development, design, engineering, testing, start-up and pre-production activity, and finally mass production. Thus the response of the economy to decisions in the private sector and to changes in policy in the public sector is essentially rather slow and cumbersome on the supply side of the market.

Unemployment

The high unemployment of the late 1950's and early 1960's was basically the result of a lack of adequate total demand, not of technological or structural changes in the economy. A decade ago, automation and technological change were thought to be displacing labour on a scale that would make the achievement of high employment impossible—that the growth of new technologically advanced jobs would leave a large supply of relatively unskilled, disadvantaged workers unemployed. Structural shifts in industrial activity, in occupational and skill requirements, and in location of economic activity were thought, in some quarters, to be piling up unemployment

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[1] Paul McCracken, in a paper presented to the annual meeting of the Canadian Economic Association, Toronto, June 5, 1969.

[2] It may also be noted that once supply in labour or product markets has been restrained or impaired, as for example occurred in the case of the housing supply following the conditions of heavy monetary restraint in 1966, it takes a very considerable time before supply can again be increased to adequate levels.

among individuals who were becoming "disadvantaged" in one way or another. But the 1960's have clearly demonstrated that the economy can undergo very substantial and rapid structural changes, and can absorb a very great amount of automation and technological change, while at the same time keeping employment high if demand growth is sufficiently strong to absorb the growth of potential.

Expectations and Instability

In the 1960's the role of expectations appears to have been considerably more important than many observers might have been prepared to anticipate a decade ago. Expectations may have a significant effect on lags in the economic system. The late 1950's and early 1960's demonstrated that once a large degree of slack has been allowed to accumulate, with high unemployment and confidence badly shaken, the psychological attitudes which such circumstances produce work to inhibit the recovery process. On the other hand, once inflationary pressures have developed over a prolonged period of rapid economic growth, with rising wages and profits and high levels of employment, expectations may become deeply entrenched and operate to frustrate the effects of policies of restraint. Businessmen then begin to make investment decisions on the basis that prices may be higher next year; employees bargain for higher wages with an allowance for the expected price erosion of their income; lenders seek rates of interest which protect them against anticipated erosion of their capital; decision-making in every field becomes dominated by behaviour designed to evade the consequences of expected continued price increases.

In Canada, the expectation of continued inflation persisted in the late 1960's even in the face of powerful monetary and fiscal restraints which had the effect of raising the level of unemployment and creating some slack in the economy.

Instability of Construction

Still another major lesson of the 1960's, and a striking feature of the economy's behaviour to which the Council drew attention in its *Third Annual Review,* is the marked instability in the construction industry. Because of the great volatility of demand for construction goods, marked by extreme swings from large increases to large declines, this industry has been unable to develop regular, sustained and steadily improving productivity performance. During periods of strong expansion, all three components of construction demand—residential, non-residential, and government—have tended to surge forward together. This has created pressures that have not only driven up wages, costs and prices in this sector, but have also made construction a source of inflationary difficulties for other parts of the economy. Moreover, these strong surges in construction investment have contributed to excessive levels of overall demand in the economy. But after a boom subsides, employment in the industry drops sharply, and workers who have been attracted during the boom are forced to find other employment (or become unemployed). The industry then adjusts to this lower base until the next burst of activity occurs. This recurrent instability of construction demand, and the repeated process of gearing up this industry to meet strong surges in activity, followed by lengthy periods of slack, have continued to hamper the development of much needed efficiencies in the construction industry. The construction industry in the 1960's thus continued to be a major source of instability in three separate and interrelated areas—in the field of wages, costs and prices; in the area of total demand; and in the field of employment.

High Employment and Price Stability

The most notable shortfall in economic performance on a worldwide basis in the 1960's, and a major unresolved problem for policy, has been the inability to bring about an acceptable reconciliation between high employment and relative price stability. This is one of the matters to which we will be turning, in a Canadian context, in the next section of this report.

The experience of the early 1960's suggests that if substantial economic slack builds up in the North American economy, the rates of general price and cost increases will gradually moderate. But the experience of the mid-1960's suggests that in the process of reducing unacceptably high unemployment and moving back towards potential, a powerful expansionary momentum may be built up in the economy, with accompanying inflationary dangers in its later stages as high levels of employment are being approached.

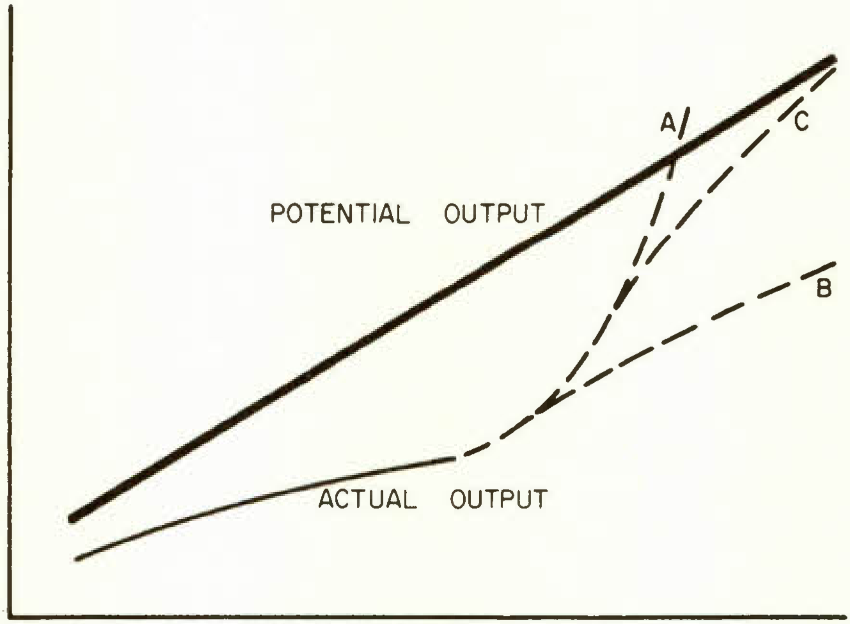
In retrospect, the Canadian economy clearly moved up too strongly in 1965 and 1966, as the economy, after taking up much of the slack of the early 1960's, neared potential (see Chart 5). We, ourselves (in our *Second Annual Review*), along with many others in 1965, underestimated the strength of prospective demand that emerged from an extraordinary combination of factors—the unanticipated increase in U.S. involvement in Vietnam, the sustained strength of the capital investment boom, the sudden upsurge of government spending in Canada, the speed and scale of the impact of the Automotive Agreement with the United States, the conclusion of new wheat export agreements, and the sharp acceleration of exports across a broad front.

Two important conclusions flow from this experience. One is that improved information and analytical techniques are required to recognize when rates of expansion are becoming excessive and might head the economy into inflationary troubles. Our evolving analysis of the performance of the economy in relation to potential has had this concern very much in mind. The second is that if a significant amount of slack should emerge and persist in the Canadian economy in 1970-71—as now appears probable—great care must be taken to move in a more gradual way back to potential in order to avoid the excessive surges of inflation-creating demand such as occurred in the mid-1960's and pushed the economy hard against potential.

Chart 19 illustrates, purely in a hypothetical way, some alternative growth paths from a situation of economic slack. On the left-hand side of the chart, a rising gap between potential and actual output is depicted, with a slowing in the rate of actual output growth (incidentally, as the chart indicates, a significant shortfall can emerge between actual and potential output without an economic recession—that is, without an actual downturn in the level of output). The right-hand part of the chart indicates three growth paths: A, a path of strong and quick return to potential; B, a path in which growth is resumed at the potential growth rate; and C, an intermediate path in which the actual growth rate increases more rapidly than the potential rate but much less rapidly than in the A path, so that the level of total actual output approaches potential output gradually. The A path is likely to take the economy back too quickly to potential; in this case, actual output would threaten to press beyond potential, and would undoubtedly give rise to serious pressures and instabilities. The B path implies that although actual output rises at the same rate as potential, it is moving parallel to the latter with a sustained significant gap, involving lost output and income in a continuing way. The C path is a preferable alternative as an objective for the resumption of growth from a situation of significant economic slack—a path which moves up initially more rapidly than potential, and hence reduces slack, but which subsequently approaches potential output in a slow and gradual way—in a way that would help to minimize the dangers of touching off excessive pressures and instabilities as the productive resources of the economy become more fully utilized.

CHART 19

GROWTH PATHS FROM A SITUATION OF ECONOMIC SLACK



Note: The growth paths illustrated in this chart are purely hypothetical.

This is a matter to which we return later in our discussion of desirable growth-path objectives for economic policy. With possible instabilities in investment, with imperfections and rigidities of various kinds in the economic system, with changes in expectations and other volatile influences on economic decision-making, and with external conditions that are not always favourable for Canada, achievement of a C-type of growth path which gradually closes the gap between actual and potential output is never likely to be easy. But we believe that this is the type of growth path that would be appropriate and that should be in the minds of decision-makers in all parts of our economic system in the shaping of their policy strategies and decisions when the recent slowdown in economic growth in Canada comes to an end.

5

Challenges for the 1970's

There are many economic challenges for Canada in the 1970's. A large number of them arise from questions about how Canadians wish to make use of their growing resources to meet the future aspirations of their society—about how to determine priorities among the vast and growing list of competing claims on national productive capabilities, and about how our economic system can serve these ends in the most appropriate and effective ways.

Another group of challenges—those with which we are basically concerned here—are the economic performance challenges. These arise in the context of five basic economic and social goals—full employment, a high and sustained rate of economic growth, reasonable price stability, a viable balance-of-payments position, and an equitable distribution of rising incomes. During the past quarter-century they have become, both in Canada and elsewhere, more comprehensive, more explicit and more ambitious. They may also have become more difficult to attain consistently, especially under conditions of increased international economic interdependence, rapid urbanization, the substantial shift towards the service industries, and swift technological and other change. The key requirement for sustained good performance in relation to these goals is that they must be achieved concurrently, even though they are not all complementary and reinforcing. We have viewed the following performance challenges of the 1970's against the background of these considerations.

Measuring Up to Potentials

In the 1960's, Canada entered a period of accelerated potential growth, arising mainly from the accelerated growth of its labour force, and hence of potential employment. The extended period of exceptionally high birth rates from the late 1940's through the 1950's means that there will be large numbers of new entrants into the labour force in the 1970's. As a result, Canada's potential growth rate will be high for the 1970's, both in relation to historical experience in Canada and in relation to the potential growth rate of most other industrial countries.

To attain potential output in 1975, Gross National Product (in constant 1969 dollars) will need to rise at an average annual rate of about 5½ per cent from 1969 to 1975. This would imply an increase (in terms of 1969 dollars) of over $30 billion to a level of close to $110 billion in 1975. Over the last half of the 1970's, the potential growth rate of the Canadian economy would still be high—over 5 per cent. This would imply a further increase in GNP in the latter part of the 1970's of about an equivalent real dollar magnitude, so that potential GNP by 1980 would be roughly of the order of $140 billion (in 1969 dollars).

A very large rise in employment will be needed to reach the full-employment potential of the economy by 1975—about 1.3 to 1.4 million more jobs than now exist in 1970. Moreover, over the 1975-80 period, about 1.2 million additional jobs will be required. In other words, at least 2½ million net new jobs will be required in Canada over the coming decade.

Along with this, there will be a need for a large rise in new capital investment to provide both equipment and structures for the rapidly rising numbers of employed persons, and housing and other social capital—especially in the country's rapidly growing urban areas. On the basis of the calculations underlying our *Sixth Annual Review*, the volume of total government and private investment is estimated to rise by well over 7 per cent per year from 1969 to potential in 1975, or from $17 billion in 1969 to over $26 billion in 1975 (in constant 1969 dollars). This includes, among other things, an allowance for building more than 1¼ million new housing units over these six years.

The maintenance of a strong growth rate in productivity—that is, the efficiency with which labour, capital and other productive resources are used—will also pose a major challenge. Productivity growth is at the heart of the process of economic growth. It is the essential means, in the longer run, of achieving higher standards of living and an enhanced quality of life for all Canadians. Also, Canada will almost certainly be facing heightened competition in world export markets in the 1970's, from both developed and developing countries, and in both resource and highly manufactured products.

In these circumstances, the maintenance of strong and sustained productivity growth is a matter of central importance to the satisfactory performance of the economy as a whole. Moreover, given the highly capital-intensive nature of the Canadian economy, continued access to outside sources of capital will be required throughout the 1970's. Under conditions of well-sustained world growth, the coming decade is likely to be one of heavy competing demands for world supplies of capital. This makes it imperative that available capital be managed with a high degree of competence and efficiency.

There are, of course, some factors that will operate to support improved productivity growth in the 1970's, notably the rising levels of experience, skills and educational attainments of the labour force. But there are also some other factors that may tend to increase the difficulties of sustaining good productivity growth—for example, the smaller scope for reallocating resources from some sectors in which average *levels* of productivity have been relatively low, such as agriculture and fishing, to other sectors in which they are relatively high.

A new ingredient in the challenges both for adequate job creation and for productivity growth in the 1970's will be the unprecedented flow into the labour markets of high-level manpower from the post-secondary educational systems. This influx of highly educated manpower should provide some of the initial returns from the vast public investment in education that was made during the 1950's and 1960's. This expansion involved, among other things, an attempt to enlarge the availability of high-level manpower. Undergraduate enrolment in universities increased during the 1960's at a rate of over 10 per cent per year and graduate enrolment at over 20 per cent per year. At the same time a new system of postsecondary institutions in the form of community colleges and institutes of technology was established.

The returns from the expansion in education could be substantial during the 1970's. But greater attention needs to be directed to the possibilities here, and various adjustments are needed in the private and government sectors of the economy in order to employ effectively and productively the rapidly rising volume of high-level manpower. The U.S. economy has demonstrated that effective use can be made of larger proportions of more highly educated manpower than now exist in Canada. But the magnitude of the adjustment problems should not be minimized, if surpluses or underutilization of such people are to be averted in Canada, during this period of very rapid growth in the supply of such manpower flowing from the educational system.

Adjustments in the recruiting and manpower utilization policies and practices of employers are needed. Adjustments may also be required in the attitudes and training of some of these highly educated young people whose schooling could prove to have been too highly concentrated on academic matters in the light of the types of jobs that are most likely to become available during the 1970's. The universities must increasingly face the challenge of giving greater attention to preparing students for nonacademic employment and for flexible adaptation to changing patterns of job opportunities which cannot be easily and accurately anticipated.

Behind these tremendous challenges of appropriate new job creation, new capital formation and sustained productivity growth, lie other major challenges—the challenge of generating a large (but not excessive) growth in demand, the challenge of achieving a high rate of domestic savings and adequate access to external capital, the challenge of facilitating flexible adjustments to fundamental structural changes in patterns of production and consumption, to mention only a few.

Price Stability

No less important in the 1970's will be the challenge of reconciling good performance in price stability with good performance in relation to employment and growth potentials. We have never regarded full employment and price stability as "either/or" objectives. Rather, the essential challenge is to pursue both of these goals together in a balanced way and in a longer-run time perspective.

Reconciliation of the employment and price goals will require the application of more than the "big levers" of monetary and fiscal policy. What is required, in addition to appropriate operation of the demand policies, are other policies that can reach into the economic process to stimulate productivity growth, strengthen competitive forces, and eliminate rigidities that often exist on the supply side leading to inflationary pressures and expectations. These structural rigidities cannot be eliminated by monetary and fiscal restraints.

The maintenance of price stability in our view is a *long-run challenge*. Indeed, only if we approach this goal on this basis, are we likely to achieve a price performance consistently as good as, or better than, that of the United States and other industrial countries. It should therefore be viewed as a continuing task *for the whole decade ahead*—perhaps even one that could become an increasingly difficult challenge. Inflationary forces are highly complex. They emanate from both domestic and external sources, from both demand and supply imbalances, from structural shifts and institutional rigidities, from a wide range of cost and income pressures, and from lack of adequate resistance, for various reasons, to such pressures. International price changes will have a significant influence on Canada's price performance in the 1970's. But so will domestic conditions. In this context, much attention is generally focused on demand conditions—and with good reason, for this is a highly important matter. But more attention needs to be devoted to other matters that are no less important—including supply, cost and competitive conditions; the bases for achieving strong productivity growth to facilitate stability (and, wherever possible, reductions) in unit labour and capital costs; and the instabilities and cost increases in the housing sector, which have made it a major source of inflation.

In this context, there are two special problem areas to which Canadians will need to devote more attention in the 1970's. One is the challenge of finding appropriate conditions under which the construction sector, which has become a major source of instability in the economy, may better serve the public interest and its own interests. The other is the even more important challenge of finding effective means for limiting the broad tide of inflation flowing from the rapidly growing service sectors of the economy—health and education, government administration, public transportation, and even many of the commercial services. As already noted above, in these sectors, measured productivity increases appear to be low, and price increases strong and sustained. As we noted earlier, many of these activities tend to be operating on an essentially "cost-plus" basis.

Maintaining a Strong International Position

The maintenance of a strong international position will also be an important performance challenge for the 1970's. Increased exports and the maintenance of adequate access to external sources of capital are needed in order to finance both the increased imports of goods and services that Canadians will demand, and increased Canadian foreign investment and aid. Fortunately, market prospects are generally bright at the outset of the decade. We have already drawn attention to the large growth of potential markets in the 1970's among our principal trading partners. There may, of course, be significant problems in some fields (such as markets for Canadian agricultural products); these problems imply a continuing need for vigorous export effort, as well as sustained efforts to ease trade restrictions affecting these exports. On the other hand, there are broad elements of strength in the export position in forest and mineral products, as well as in various highly manufactured goods. But Canada's potential in international trade in the 1970's cannot be achieved unless producers and exporters struggle unrelentingly, with appropriate supporting government policies and programs, to enhance their competitiveness in domestic and world markets. Moreover, they may well have to do so under conditions that may not be as favourable as in the 1960's, when the substantial devaluation of the Canadian dollar was an important factor strengthening the international competitive position of many industries.

The maintenance of a strong international position will also not be assured unless international co-operation is energetically pursued by Canada and her trading partners as a mutually beneficial goal. As already noted early in this report, the past decade has been a period of rapidly growing economic interdependence among nations. This has been reflected, among other things, in the huge expansion of world trade; the greatly increased mobility of capital, technology and manpower; and the rise of the multinational corporation. This trend towards greater economic interdependence will continue to be a prominent feature of international life in the 1970's, perhaps even on an increasing scale, if world economic development is generally strong and well-sustained.

Increased international economic interdependence has, on the whole, been a factor contributing powerfully to the historical growth and development of the Canadian economy. Over a century ago, at the time of Confederation, Canada was a largely empty country, with a small and underdeveloped economy. Without inflows of people, capital, knowledge and technology from abroad, and without the development of growing external markets for Canadian products, Canada's economy would have remained small and relatively underdeveloped. But this country's high degree of international interdependence has not only brought benefits but has also given rise to problems. A general trend towards increased international economic interdependence over the coming decade would not only provide new opportunities for Canadians, but would also raise new questions about how the interests and aspirations of Canadians can best be served in such conditions. One of the major challenges of the 1970's will be that of finding effective means to harness the benefits arising from widening economic interdependence to the development of a more mature and self-confident national economy.

Equitable Distribution of Rising Incomes

The more equitable distribution of rising incomes will undoubtedly come into greater prominence as an economic and social goal in the 1970's. In particular, the challenges of narrowing regional economic disparities and eliminating poverty clearly need, and will claim, increasing emphasis. There are, of course, important human and social reasons for placing more emphasis on these challenges. But there are good economic reasons too. As we have emphasized in our earlier work, poverty—especially poverty of the dimensions and characteristics evident in Canada—places an economic burden on society. It acts as a brake on Canada's economic growth and imposes economic costs that detract from the well-being of *all* Canadians. Similarly, regional disparities, which reflect, in economic terms, unutilized or underutilized resources of human capital and relatively inefficient use of productive resources in low-income regions, also detract from good economic performance—not only for the region but for the national economy. Thus, for the 1970's, substantial progress towards the elimination of poverty and the narrowing of regional disparities should be considered not only as challenges that should embody concern for the human and social consequences of the existence of poverty and wide disparities, but also as major *economic performance* challenges.

6

Implications for Policy

Unfortunately, economic policy-making is not a laboratory science. The policy-maker is frequently forced by the pressure of events to make rapid decisions, often in the absence of adequate information and in the face of considerable uncertainty. He has virtually no opportunity, like the physical scientist, to test alternative courses of action in advance under carefully controlled conditions. He must learn from the experience of real events.

The sharp contrasts in Canadian economic performance over the past decade and a half provide a rich reservoir of experiences for such a learning process. We have discussed some of these experiences in considerable detail in the earlier sections of this report. On the basis of these discussions, the Council feels that certain implications for policy emerge quite strongly. We draw attention to these under five major headings:

—basic strategies for policy in the early 1970's;
—longer time horizons for policy-planning;
—housing and construction;
—policy co-ordination; and
—good performance and public understanding.

Not surprisingly, the conclusions we set out under each of these headings are often highly interdependent.

Basic Strategies for Policy in the Early 1970's

The Canadian economy has enormous potential for growth over the next few years. Any shortfall from this potential can, of course, be depicted by the experts in terms of cold, impersonal measures such as Gross National Product. But beneath this statistical veneer it means fewer jobs, lower incomes, and fewer resources to help meet our diverse and expanding aspirations. On the other side of the coin, any attempt to force the economy to operate above its potential output trend can result in a further round of inflation and other imbalances, with all their attendant inequities and dangers.

Our recent experience reinforces the view that imbalances in one direction are very likely to breed imbalances in the other direction. With the gap between potential and actual output apparently around 4 per cent in 1970, the Council urges that:

—Policy should now be very much concerned with preventing a further build-up of economic slack. Significant slack not only imposes immediate hardships, it also gives rise to greater policy-making difficulties in the period ahead, when the economy moves again towards its longer-run potential. What is now required is a resumption of growth in real output in excess of 5 per cent per year as soon as possible. Some steps in this direction have, as we have noted earlier, already been taken—for example, some easing in monetary policy and some decisions to increase government spending. But in this context, we would draw attention to the need for present and future evaluation of fiscal policy on a high-employment budget basis for all governments combined; on this basis, as indicated in the preceding analysis in this report, fiscal policy coming into 1970 was tending to hold the economy well below its growing potential output.

—The public should be aware that a very critical point for demand-management policies will come after the economy begins to close the gap between actual and potential output. There is, we feel, a strong underpinning of potential demand in the economy. In such circumstances, unduly rapid expansion to the economy's total output capabilities could take place if demand forces are allowed to gather too much momentum. In other words, we urge what might be termed a policy of "gradualism" when approaching potential in the future (as illustrated by line C in Chart 19 in the preceding section of this report). This is fully consistent with a strong, sustained growth of total demand through the 1970's, in the context of the very large growth capacities for both employment and output in the economy over the coming decade.

—Greater recognition should be given to the fact that the problems of inflation are not simply a distasteful event of the present or recent past, but are, in part at least, a reflection of the attempts in most Western countries to run high-employment economies with inadequate emphasis on supply, structural, and other policies as essential complements to appropriate demand policies.[1] The potential dangers of inflation could be at least as acute in the 1970's as in the 1960's. It is therefore essential to shift to a longer-run approach to these dangers that will attack more directly some of the underlying imbalances and rigidities from which they arise, and enhance expectations of reasonably stable prices. In this context, more attention is needed to the timely development of adequate supply to meet anticipated demand growth in many fields, such as housing, transportation, educational and health care facilities, urban services, pollution abatement, and so forth. Also, more attention is required to the anti-inflationary potentialities of good productivity performance, and to the better matching of supply to demand in the future in product and service markets, as well as in labour and capital markets.

—Fiscal policy should aim, in the circumstances of the next few years, at achieving a small but sustained high-employment budget surplus on a national accounts basis for the government sector as a whole, including the operations of federal, provincial and municipal governments and the Canada and Quebec Pension Plans. In our analysis of the medium-term future in our *Sixth Annual Review,* we called for such a small surplus at potential output in 1975. Such a surplus will be necessary to supplement the total savings from other sources to accommodate the large and varied investment needs we anticipate into the mid-1970's.

—The federal government and all provincial governments in Canada should give consideration to the necessity of framing fiscal policy within a well-functioning, organizational, analytical and statistical framework that provides the essential basis for fiscal co-ordination. We commend the progress that has been made in this direction during the past decade, but we recognize that many problems remain. We return to this subject below, under policy co-ordination.

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[1] For illustrations of specific supply and other complementary policies, see those discussed in our *Third Annual Review.*

—Monetary policy (together with fiscal policy with which it is closely interrelated) should evolve in a way that seeks to avoid large destabilizing swings in the growth of the money supply. There are long lags between changes in policy and their effects on the economy. And there are many uncertainties in short-term economic forecasting. For the creation of a stable environment for growth, we therefore consider it essential that the growth of the money supply *over the longer term* should be approximately in line with the underlying growth rate of potential output, with smaller swings around the rate of increase in potential output than have characterized past policy. Once again, we recognize that Canada's ability to pursue such a policy depends critically on whether a similar strategy is being pursued in the United States. Moreover, short-term instabilities that are frequently prominent features of sensitive financial markets may require tactical departures from the basic setting of strategy. In such cases, however, we would urge that, in the interest of more stable longer-run expectations, the reasons for such departures from the basic strategy be communicated clearly by the monetary authorities in public statements.

Longer Time Horizons for Policy-Planning

We feel strongly that there should be an accelerated movement towards the evolving practice of planning further ahead—say, over five-year periods—by governments, business and other groups, and jointly with other countries in international organizations.

There have already been encouraging developments in this direction during the 1960's. The federal government and many provincial and municipal governments have worked towards five-year schedules of estimated revenues and expenditures, and at one point, the outline of such a schedule was made public by the Federal-Provincial Tax Structure Committee. Also, new techniques of planning and program evaluation that are being developed and applied by various governments require estimation of the costs and benefits of certain expenditure programs over a number of years into the future. Experience with our own surveys of investment, manpower, and management development intentions, suggests that Canadian businesses increasingly base decisions on longer-term prospects at home and abroad. The OECD 50 per cent growth target for the 1960's (which was exceeded) turned attention towards growth prospects for members, and provided a basis for better long-range planning by governments and businesses within these countries. Similarly, the OECD growth target of 65 per cent for the 1970's provides a renewed framework of this kind.

The rationale behind our recommendation for policy-planning further ahead has already been discussed in earlier sections. In essence, it relates to the two main types of policy required for good economic performance—those that sustain market demand at consistently appropriate levels over the years, and those that operate to improve the process of the timely matching of supply with changing demand (avoiding, or at least easing, bottlenecks and costly rigidities).

The powerful "demand-regulating" fiscal and monetary instruments could be more effective if stabilization policies were framed more explicitly within the context of long-term strategy. Visible and articulate leadership in the operation of this strategy must be provided so that the strategy can be understood by the public, and especially by those who should be conducting their own policy-planning in accordance with it.

Some major elements in the kind of long-term strategy we endorse are:

—linking more public and private decisions to a framework of potential output estimates;

—developing expenditure programs by all governments more explicitly in a longer-range context, projecting and publishing *all-government* revenues and expenditures within a framework of potential analysis for the medium term, and considering how tax and expenditure programs should be adjusted in the event of departures from potential.

"Supply" policies are important for the avoidance of shortages of labour and professional skills, of housing and other facilities, and for a smooth shift of resources from low-priority to high-priority uses[1]. Longer-range planning would help to eradicate the misuse of resources involved in these developments, and could also help to reduce the magnitude of swings in business investment generally.

The experience in the 1960's shows clearly that society will require the evaluation of various activities (education, medicare, control of the environment, housing, urban and rural restructuring, and social

[1] Demand-management policies must also consistently take into account the fact that they may have important implications for supply, costs, and prices.

services, for example), where market forces in the traditional sense are not adequate for the job, and where public provision of some or all of the required resources becomes necessary. In the circumstances, there are all-too-obvious dangers of wasting resources by adopting short-run, piecemeal approaches—dangers of getting priorities wrong, of locking funds into less-productive programs, and of dealing with problems only when they have reached crisis proportions. If danger becomes reality, the emergence of price-escalating bottlenecks is virtually a foregone conclusion. In the light of these dangers, the federal government and some provincial and municipal governments have moved to develop and introduce new techniques for supporting decision-making within a longer time horizon and in a more comprehensive framework.

In our Annual Review for 1969, we recommended the association of a long-term supply strategy with a long-term strategy for demand management, to cope more effectively with the problems of reconciling full employment and price stability. The federal role in this approach would be an essential one—both internally and internationally—but provincial and municipal governments also would have key responsibilities. In the private sector, too, there is a need to plan further ahead, over a wider range of activities.

Housing and Construction

Housing is clearly in short supply, and the need for it will be rising strongly for a long time. We endorse the current federal approach of setting housing targets and of rectifying shortfalls in private activity by providing additional government resources—especially for low-income housing. In present conditions, we believe that the addition of such resources is not only socially justified, but is also consistent with an overall long-term strategy of returning to potential.

More generally, the construction industry is in a deeply troubled condition, and it appears that industry, unions, and governments are not working well together to solve critical problems. Construction is a major activity in all regions of Canada. In this case, more seems to be required than the shift towards steady growth policies that we have endorsed in the past and continue to emphasize in this report. We therefore recommend a careful enquiry—in the light of various provincial responsibilities in this field, one which should appropriately be established on the basis of federal-provincial consultation—into means of getting better solutions for the many intractable problems that are now plaguing this sector of the economy. In particular, special attention needs to be devoted to possible techniques for increasing productivity in construction.

Policy Co-ordination

It is becoming almost trite to suggest that there continues to be a requirement in Canada for greater co-ordination of policies—within governments, between governments, and between the public and private sectors. Yet, examples of conflicts in policy, or of areas where information about programs is inadequate to support co-ordination, are not difficult to find.

Even within governments, policies designed to reach certain objectives in one area may run counter to those attempting to achieve different objectives in another area. Policies of financial restraint, for example, aimed at slowing the advance in prices tend to operate with adverse effects in the housing sector. National restraints on aggregate demand may conflict with provincial and municipal policies for growth and development. Competitive industrial development policies on the part of different provinces, or even municipalities within a province, can turn out to be self-defeating.

The operation of demand-management policies would be less difficult for governments if business investment expenditures for plant and equipment were planned and phased in a more stable way over longer time periods. Such planning would avoid the "bunching" and explosive bursts of expenditure that occur all too often. At the same time businessmen would find it less difficult to plan their decisions in this way if governments were planning their own expenditures over longer time periods and making their intentions known to the private sector, and if there were explicit policy commitments to the achievement of stable growth in line with the economy's underlying potential.

But how can greater co-ordination be achieved? Too often, the recommendation for greater co-ordination is translated merely into a call for proliferation of institutional arrangements—in particular, for more meetings between decision-makers. In one vital field in Canada, that of federal-provincial relations, there are probably *too many* meetings already. Indeed, we sympathize with the officials and ministers concerned (especially those from the smaller provinces where staff resources may be quite limited) about the burden of such meetings.

So we must look in other directions, for the most part, for improved co-ordination. In this respect, the Council makes no claim to having any definitive answer—indeed we feel that the whole broad process of decision-making in governments in Canada (not simply the evaluation of specific programs) should become the subject of intensive study in the 1970's—but we do have a few suggestions for some elements of an improved system.

Policy co-ordination—whether within governments, between governments or between the public and private sector—requires some sort of comprehensive framework within which goals and priorities can be discussed on a national basis. And it requires better information and analysis than now exist as a basis for debating policy issues. These, as we see them, are some of the ingredients of a better co-ordination process in Canada:

—A comprehensive framework for the discussion of goals and priorities to which both government and private decisions could be more coherently related. A proposal for facilitating the development of such a framework was set forth in our *Sixth Annual Review*.[1]

—The annual preparation and publication of projections of expenditure for existing government programs (covering all levels of government) and of returns from taxes at existing rates, for at least five years ahead.

—The adoption of a common and comprehensive framework by the federal and provincial governments for evaluation of fiscal policy and government financial operations. We regard the present lack of a fully adequate framework of this type for consistent use by governments as a major stumbling block to fiscal co-ordination in Canada.

—Extended surveys of government and private investment intentions. The Council itself has made some progress with its own surveys of medium-term investment intentions, but there is still considerable room for improvement.

—In the case of federal-provincial relations, a further expansion of staff resources devoted to the development of information and analysis, perhaps with some provision for more permanent secretariats (with personnel rotated at regular intervals to avoid any building up of what might be termed a "new level of government"), and for drawing more than in the past on sup-

[1] Page 172.

plementary staff resources through contract arrangements. Both on a national level and within provinces, there is also a need for greatly strengthening the bases of information, analysis and program co-ordination in all matters relating to the municipalities, for Canada is now essentially an urban society.

Good Performance and Public Understanding

In a democratic country such as Canada, every citizen shares responsibility for good performance of the economy; every producer of goods and services contributes to whatever success is achieved; and every person can benefit, directly or indirectly, from good performance. If every Canadian is to play his part in the maintenance of good performance in the economy, there must be a wide basis of public understanding about how the economy works and about possible ways to make it work better.

In the final analysis, Canada's performance policies are a response to public opinion. In general, public policies cannot far outrun public understanding and acceptance. Fortunately, during the 1960's, there appears to have been greatly increased interest in public debate on economic issues in Canada. Much scope remains, however, for wider and better understanding of the goals and strategies relevant to good economic performance.

In the context of good economic performance, the basic elements of public understanding are concerned with four issues: *why* good performance is worthwhile; *what* good performance is; *how* it can be achieved; and *who* has special duties to perform. This report has touched on various aspects of *what* good performance is and *how* it can be achieved. In this final section, we consider briefly the *why* and the *who*.

The reason *why* good economic performance is a worthwhile goal is that it enables Canadians to improve their standard of living. With good economic performance, they can afford more material things and a better quality of life. Basically this is because people and resources are fully employed in a steady, productive way, thereby avoiding most of the wasteful, frustrating and degenerating effects of alternating periods of slack and overheating in the economy.

Who, then, has special duties to perform with respect to widening public understanding about good economic performance? The Economic Council recognizes that it has a continuing responsibility in this area through the medium of its publications and through various other activities in which it is involved. But other agencies also play an important role. The inflation process, its causes and cures, are worthy subjects for study and illumination by agencies such as the Prices and Incomes Commission.[1] The Dominion Bureau of Statistics has the responsibility of collecting and publishing promptly the data required for adequate monitoring of the potentials and the performance of the economy. There is a large and growing reservoir of specialists who could play an increased role in helping to raise the level of public discussion about economic affairs.

Among other groups that can perhaps play more effective roles in relation to the great challenge of communicating the what, why, and how of good economic performance to a wide cross-section of the Canadian public, we single out four for special attention.

First are the educational institutions. We recommend that high-quality teaching of economics in secondary schools be widened and strengthened. The great majority of those emerging from Canada's educational systems in the 1970's, even with a further substantial building up of these systems, will not have any formal postsecondary education. Moreover, many of those who do have opportunities for postsecondary education have little, if any, exposure to economic issues. There is therefore a great need to provide these young people with a better understanding of the economic system in which they will be living. Also, there are wide opportunities for post-secondary educational institutions to play much larger roles in adult and public education about economic affairs. They could, for example, provide more courses and public lectures on economic topics (such as the performance of the economy), both on and off campus.

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[1] Indeed, the Prices and Incomes Commission was essentially established for this purpose. The Minister of Consumer and Corporate Affairs, when announcing the establishment of the Commission in May 1969, stated that its terms of reference would be:

> "...to inquire into and report upon the causes, processes and consequences of inflation and to inform those making current price and income decisions, the general public and the Government on how price stability may best be achieved".

These terms of reference, in turn, reflected those set forth in the 1968 White Paper on *Policies for Price Stability*. In the latter, the central duties of the Commission were set out in the following terms:

> "It [the Commission] will be charged with the responsibility for conducting studies of price and income developments in Canada, and for producing regular reports on its findings. The purpose of the Commission will be to *discover* the facts, *analyze* the causes, processes and consequences of inflation, and to *inform* both the public and the Government on how price stability may be achieved."

Second are committees of the federal parliament and provincial legislatures. Some of these have been accomplishing a good deal in raising the level of public debate in economic affairs. The work of many of these committees deserves wider public attention. Moreover, their work would be greatly strengthened, and their contribution to the parliamentary process and to public understanding of economic issues greatly enhanced, if they were more widely and adequately supported by competent research staff.

Third are the mass media. Reporting and commentary on economic affairs by the mass media have improved significantly in a number of respects in Canada over the past decade. But in view of the very important role which these media play in contributing to public understanding about economic developments, problems and policies, various possible ways in which continued improvements could be made in their reporting and appraisal roles would be useful. This is, of course, only one aspect of the wider issue of the increasingly important role which the media are, and should be, coming to play in many fields of special knowledge in what is being called the "knowledge society". As regards the field of economics, we would draw attention to:

—the advantages that might be derived from having media representatives take more initiatives in arranging for discussions and seminars with specialists and policy-makers as a background to reporting and analysis of economic affairs;

—the feasibility of steps to establish, on the basis of joint support by a number of organizations in the mass media field, an economic information and analysis agency that might provide a common pool of economic expertise available to supporting members (and perhaps also to serve as an organization providing wider public services—for example, the Japan Economic Research Centre, which was established only seven years ago and is already one of the best-known economic research organizations in the world, owes much to leadership emanating from the Japanese press); and

—the strengthening of the bases for high-quality reporting about economics over a whole range of supporting activities—for example, through improved education in journalism and through greater efforts on the part of those disseminating information to the media to make sure that relevant material is made available and that it is timely, understandable and useful.

Fourth, are business organizations, professional associations, labour unions and other private interest groups. We believe that there are important opportunities for these groups, perhaps especially for business and labour organizations, to enlarge the contributions they have been making to the development of improved understanding of economic issues and of the effects of both public and private decisions on the performance of the economy. Such contributions could take many forms, including the information which these associations disseminate regularly to their members and through conferences, meetings and seminars.

Conclusions

A major concern of this report is that the Canadian economy has fallen significantly below its potential. A quick return to potential is not feasible. But the central challenge is to begin to close the gap between actual and potential performance as soon as possible—to begin to reduce the significant human and economic costs of high unemployment—bearing in mind the need to maintain reasonable stability of prices. It is important to recognize that the present degree of slack, reflected partly in high unemployment, will tend to persist and grow until an annual rate of real growth in excess of 5 per cent is resumed.

The current slack in production and employment is a source of widespread concern among Canadians. Moreover, a wide variety of uncertainties are emerging that contrast with the highly expansionary expectations prevailing over much of the past decade. The sources and effects of these uncertainties include a series of recent developments such as the economic slowdown itself and high unemployment, persisting price and cost increases, high interest rates and troubled financial markets, depressed profits, protracted labour-management disputes, and serious difficulties in the wheat economy of Western Canada. Many questions and uncertainties have also arisen about the tax reform proposals in Canada and the slowdown in the U.S. economy.

However, there are some signs of firming in the North American economy as a whole. Also, demand-management policies in Canada and the United States have become less restrictive. Further, the medium-term growth potential of the Canadian economy is exceptionally large. It is important, therefore, that recent and current difficulties and problems be kept in proper perspective and that a climate be created in which decisions will be based on confidence that our economic potentials can be substantially realized in the medium-term future.

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