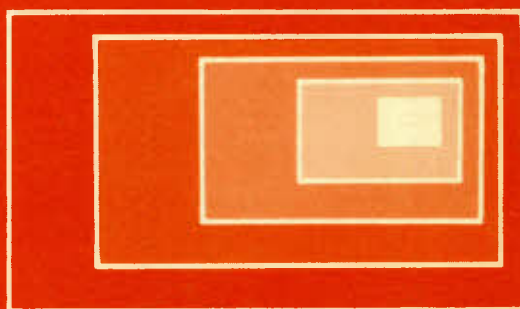




ECONOMIC COUNCIL OF CANADA

Fourteenth Annual Review



Into the 1980s



HC
111
.E26
n.14

c.1
tor mai

1977

Into the 1980s

ECONOMIC COUNCIL OF CANADA

Fourteenth Annual Review

Into the 1980s



1977

© Minister of Supply and Services Canada 1977

Available by mail from

Printing and Publishing
Supply and Services Canada
Ottawa, Canada K1A 0S9

or through your bookseller.

Catalogue No. EC21-1/1977
ISBN 0-660-01469-8

Canada: \$2.00
Other countries: \$2.40

Price subject to change without notice.

CAN.
EC21-
1/1977

Contents

1	The Canadian Economy in 1976 and 1977	1
	Overall Developments	1
	Prices and Costs	5
	The Labour Market	9
	Incomes	12
	Conclusion	13
2	The Struggle against Inflation	15
	Developments to 1975	15
	The Controls Program	16
	Wage Controls	17
	Price and Profit Controls	18
	Assessment of the Program	19
	A Step Beyond . . .	21
	Monetary Policy	21
	Fiscal Policy	24
	Conclusion	28
3	Trade Balances and Prospects	29
	Problems in the Current Account	29
	Merchandise Trade	30
	Food, feed, beverages, and tobacco	31
	Raw and fabricated materials	31
	End products	33
	Services	34
	The Impact of the Exchange Rate	35
	Canada's Trade Prospects	36
	The Spectre of Protectionism	37
	The Current GATT Negotiations	39
	Freer Trade and Industrial Adaptation	41
	Conclusion	44
4	Savings, Investment, and Capital Flows	45
	Savings	45
	Investment	49

Capital Flows	53
Portfolio Investment	55
Foreign Direct Investment	57
Canadian Investment Abroad	59
Foreign Borrowing and International Indebtedness	62
Conclusion	63
5 Policy Options for the Years 1977 to 1982	65
Some Initial Assumptions	66
The Reference Solution	68
Alternative Scenarios	69
A Tighter Monetary Policy	69
Personal Income Tax Cuts and Higher Government Spending	71
Personal Income Tax Cuts Only	73
Personal Income Tax Cuts and Sales Tax Reductions	73
Personal Income Tax Cuts and Tighter Monetary Policy	74
Expansionary Monetary Policy	75
Conclusion	75
6 Conclusions and Recommendations	77
Structural Problems	78
International Competitiveness and . . .	78
. . . Industrial Adaptation	78
The Balance of Payments and Foreign Borrowings	79
Unemployment	81
Energy Conservation	83
Intensifying the Effort	83
Monetary Policy	84
Fiscal Initiatives	85
New Consultation Initiatives	90
Conclusion	91
Appendix Table	92
List of Tables	94
List of Charts	95
List of Project Staff	96

This report reflects a consensus of the Economic Council of Canada, except for the reservation entered by M. Bélanger and R. M. MacIntosh on page 85.

Members of the Council

GEORGE POST	Acting Chairman
IAN ANDREW BARCLAY	Chairman and Chief Executive Officer British Columbia Forest Products Ltd. Vancouver, British Columbia
MARCEL BÉLANGER, C.A.	Bélanger, Dallaire, Gagnon and Associates Quebec, Quebec
S. ROBERT BLAIR	President and Chief Executive Officer The Alberta Gas Trunk Line Company Limited Calgary, Alberta
J. A. BROWN	Dean of Agriculture University of Saskatchewan Saskatoon, Saskatchewan
MS. PAT CARNEY	President Gemini North Ltd. Vancouver, British Columbia
CHARLES J. CONNAGHAN	Vice-President Administrative Services University of British Columbia Vancouver, British Columbia
GÉRARD DION	Professor Department of Industrial Relations Université Laval Quebec, Quebec
ROY FRASER ELLIOTT, Q.C.	Partner Stikeman, Elliott, Robarts and Bowman Toronto, Ontario
MS. YOLANDE LAVIOLETTE	La Fédération de Québec des Caisses Populaires Desjardins Lévis, Quebec
ROBERT M. MACINTOSH	Executive Vice-President The Bank of Nova Scotia Toronto, Ontario
JAMES A. MCCAMBLY	Executive Secretary Building and Construction Trades Department Ottawa, Ontario

Members of the Council ix

HELEN K. MUSSALLEM	Executive Director Canadian Nurses' Association Ottawa, Ontario
HON. H. A. OLSON, P.C.	Senator, Rancher Iddesleigh, Alberta
RAYMOND PRIMEAU	Professor Department of Industrial Engineering École Polytechnique de Montréal Montreal, Quebec
STEVE RANKIN	Head of Sales Nova Scotia Forest Industries Port Hawkesbury, Nova Scotia
A. M. RUNCIMAN	President United Grain Growers Ltd. Winnipeg, Manitoba
WILLIAM E. HAVILAND	Secretary

Into the 1980s

1 The Canadian Economy in 1976 and 1977

Canada's economic recovery has been slower than that of most other western industrial nations and more sluggish than earlier cyclical upturns in this country. A policy of fiscal restraint has held back government spending, which is often a significant catalyst in the resurgence of an economy. Moreover, a high degree of idle capacity in industry, a large reservoir of unused labour, and some uncertainty about Canada's economic future have all helped to limit business and consumer expenditures. The net effect is a condition of relatively weak aggregate demand, in which only primary exports are finding favourable markets. On the positive side, however, is an easing of the double-digit inflation rates that prevailed in 1974 and 1975.

Overall Developments

While real gross national expenditure (GNE) grew by 4.9 per cent in 1976, this increase was mainly concentrated in the first six months of the year (Chart 1-1). This growth was largely sustained by consumer expenditures on goods and services, particularly on semidurable and nondurable goods. Total fixed investment hardly increased at all, and residential construction was almost entirely responsible for the growth that did occur in this area. Thanks to successful government assistance programs, housing starts reached an all-time high of 273,000 units in 1976. Government expenditures on goods and services were constrained at all levels, advancing at less than 1 per cent.

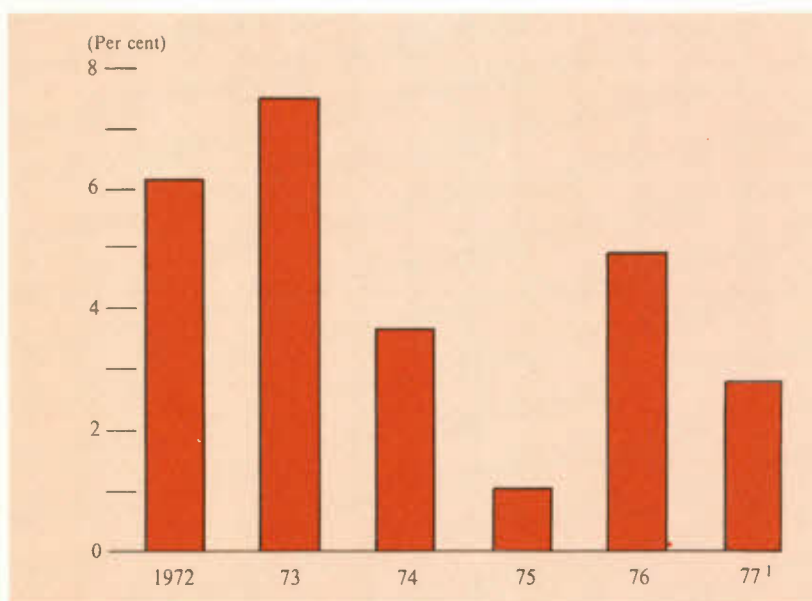
The last two quarters of 1976 registered a decline in real output. A surge in real GNE in the early months of 1977, resulting mainly from increased exports, turned out to be only temporary. The first half of 1977 saw a sharp deceleration in the growth rate of consumer spending, which reflected a slowdown in the growth of real disposable income as well as continuing high levels of savings. Total fixed investment has increased only slightly since the beginning of 1977, with housing starts dropping to more modest

2 The Economy in 1976 and 1977

levels than in 1976. Narrowing differentials between the rates for the government's Assisted Home Ownership Plan (AHOP) for new homes and those for conventional financing of existing homes for resale have contributed to reduced demand for new homes and increased demand for existing structures. Nonresidential construction picked up this year. On the other hand, investment in machinery and equipment increased slightly, mainly as a result of engineering expenditures; with the heavy overhang of unused capacity, it remains weak.

Chart 1-1

Annual Change in Real Gross National Expenditure,
Canada, 1972-77



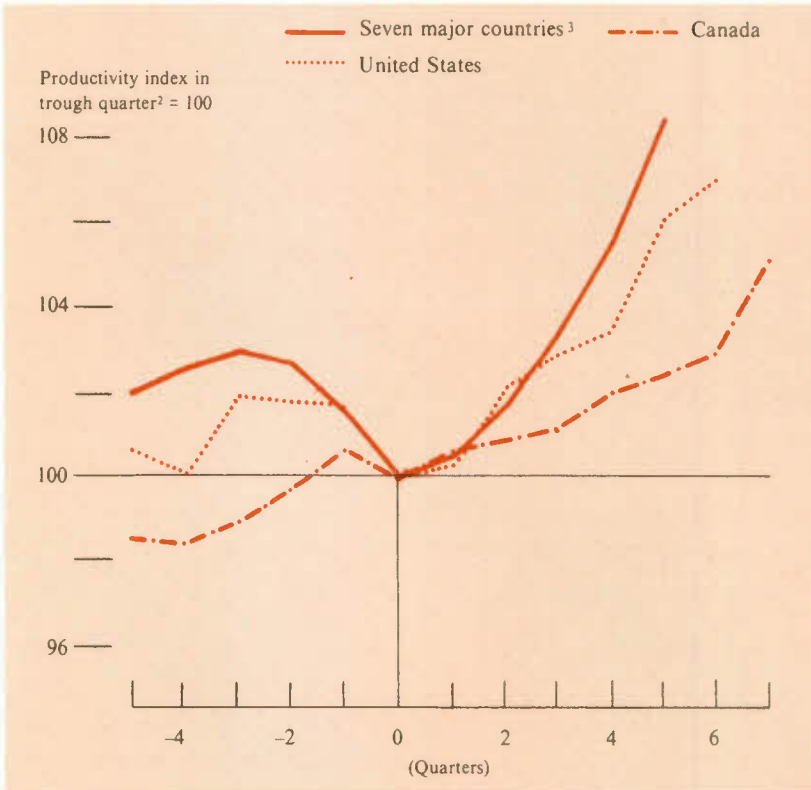
1 Estimates.

SOURCE Based on data from Statistics Canada.

Although productivity registered some cyclical advance in 1976, this improvement was less favourable than that at similar stages in previous recovery periods. It was limited by slow growth in output and a substantial amount of underutilized plant and equipment as well as labour. Canada's recent performance in productivity falls well behind that of the United States and a combined index for seven of the largest manufacturing countries within the Organisation for Economic Co-operation and Development (OECD), as Chart 1-2 shows. Caution is warranted when comparing short-run productivity changes, however, since performance in an upswing is largely affected by the extent of the preceding downturn. The 1974

Chart 1-2

Cyclical Developments in Productivity Index,¹
Major Industrial Countries, 1973-76



1 Defined here as output per man-hour in manufacturing.

2 Quarter 0 represents the trough quarter, which varies from country to country.

3 Composite index for Canada, France, Italy, Japan, the United Kingdom, the United States, and West Germany.

SOURCE Organisation for Economic Co-operation and Development, *OECD Economic Outlook*, no. 20, December 1976.

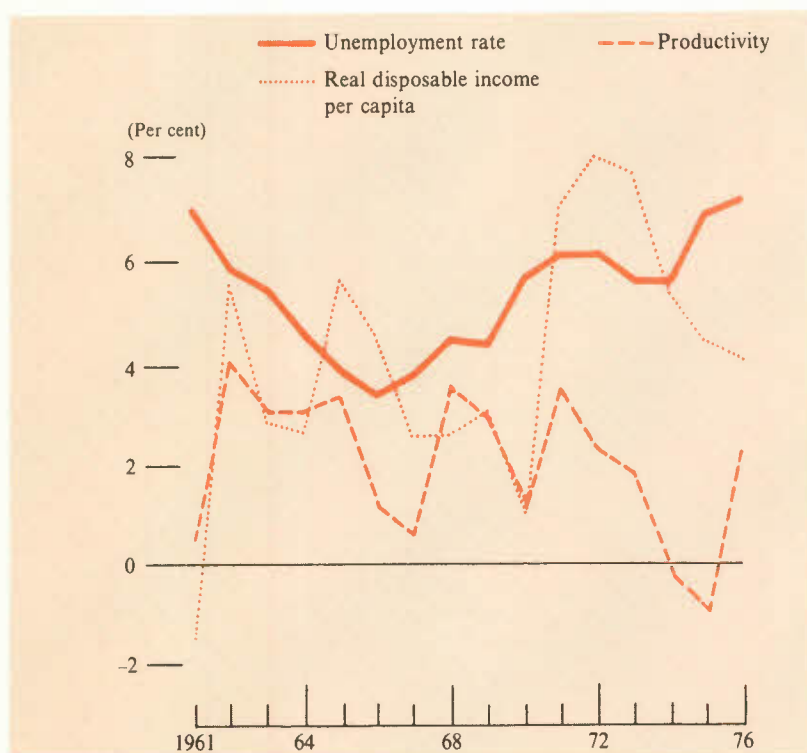
recession in the United States was substantially more severe than in Canada; and output in U.S. manufacturing industries since the trough of the cycle has been growing at a much faster pace, thus allowing for greater productivity gains than in Canada.

A study of the growth patterns of real disposable income per capita, unemployment, and productivity since 1960 leads to the question: why was disposable income able to expand as it did from the late 1960s to the mid-1970s, although unemployment levels were rising and productivity gains were at a relatively low ebb (Chart 1-3)? While increased transfer payments played a role, the critical factor seems to be linked to demographic shifts and to significant increases in the proportion of Canadians who were

4 The Economy in 1976 and 1977

Chart 1-3

Annual Unemployment Rate and Annual Change in Productivity and Real Disposable Income per Capita, Canada, 1961-76¹



1 Productivity is defined as output per person employed. Data on employment (for the measurement of productivity) and the unemployment rate for the years 1960 to 1965 are based on the old Labour Force Survey, while data for subsequent years are based on the revised Survey.

SOURCE Based on data from Statistics Canada.

employed and received an income. Before 1960, most of the children born during the postwar baby boom were in school, and female participation rates in the Canadian labour force were low compared with those of most other western nations. With new emphasis being placed on family planning and with the approaching maturity of the postwar generation, however, the early 1960s saw the beginning of a decline in the proportion of dependants relative to family members at work — that is, the dependency ratio. By the end of the 1960s and early 1970s, the postwar generation was joining the labour force, as were many mothers who were responding to rapid growth in the numbers of full- and part-time jobs in services, government, and related sectors. In the fifteen years between 1961 and 1976, female participation rates rose from 23 to 45 per cent. As more and more young people and married women sought jobs, there was an expansion both in employment and unemployment, as well as pronounced growth of real disposable income per capita.

Today, the average urban prime-age family has two or more sources of income. The number of young school-leavers seeking employment is beginning to drop. The decline in the dependency ratio seems to be slowing, although, to some degree, the drop in the proportion of children is being offset by an increase in the number of old persons. It is therefore unlikely that we will soon again see real personal income per capita increase at the rates witnessed during the past decade. Per capita gains will be determined mainly by productivity per worker, and the outlook there is one of continued slow growth.

In summary, with weak private investment, low growth of public expenditures, moderate export growth, faltering productivity, and a slowing advance of consumer expenditures as a result of decelerating increases in real personal income per capita, the recent performance of the Canadian economy has been relatively listless, and immediate prospects are only moderately favourable.

Prices and Costs

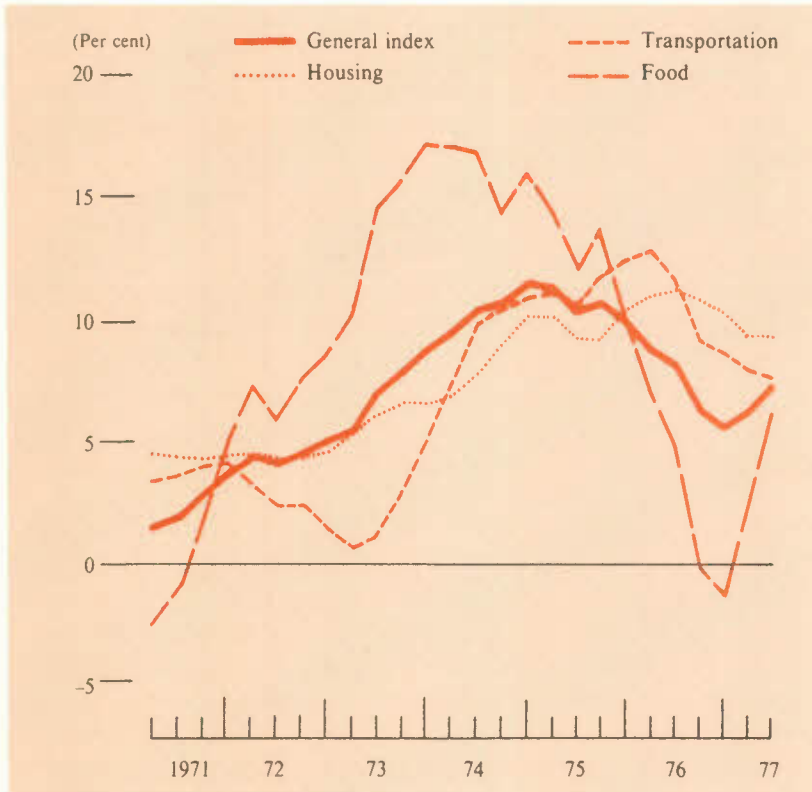
After fairly rapid deceleration of price increases during the latter half of 1976, consumer prices have picked up again in 1977 and the increase in the consumer price index (CPI) will probably average about 7.5 per cent for the year (Chart 1-4).¹ While this still represents a considerable improvement over 1974 and 1975 figures and while it coincides with the average inflation rate in most other major OECD countries, it is somewhat disappointing in light of the federal government's 6 per cent target for 1977. Higher world food prices, energy prices, and import costs resulting from the depreciation of the Canadian dollar have all contributed to the rise. Perhaps even more worrisome is the renewed upward trend of the wholesale price index — a measure that tends to lead the CPI in its cyclical ups and downs.

Rising energy costs have led directly or indirectly to higher prices in almost all sectors of the economy. They have particularly affected utility, home fuel, and transportation expenditures, which together have accounted for half the increase in the cost of living this year. By July 1977, the price of oil at the wellhead had reached \$10.75 per barrel. At \$1.68 per thousand cubic feet (Toronto price), natural gas is relatively undervalued in comparison with crude oil, considering its "clean-burning" characteristics and the fact that one barrel of oil yields roughly as much energy as 6,000

1 The consumer price index is designed to monitor price changes for a given bundle of goods based on the 1967 expenditure patterns of a family consisting of two to six persons, with an income of \$4,000 to \$12,000. A new consumer price index based on 1974 expenditure patterns will be released shortly and will have no restrictions on family size or income levels.

Chart 1-4

Year-over-Year Change in Selected Components of Consumer Price Index, by Quarter, 1971-77



SOURCE Based on data from Statistics Canada.

cubic feet of natural gas. Natural gas prices will be increased by 10 per cent by February 1978, and the federal government intends to add a further \$3.00 to wellhead oil prices in three stages over the next eighteen months. Although the Canadian price is gradually approaching the international level, the consumer can nevertheless have some consolation in knowing that energy costs in most other western countries are equally, if not more, onerous (Table 1-1).

Canada's longer-term energy strategy is two-pronged: to increase domestic energy supplies and to decrease the growth in domestic demand, primarily through the price mechanism. Canadian industrial and private consumption habits are still attuned to relatively low energy costs. Indeed, despite the tripling of prices and the greater use of insulation and other energy-saving measures, including the use of smaller automobiles, energy consumption per capita has hardly declined from the level observed four

Table 1-1

International Comparison of Selected Energy Prices, April 1977

	Price of heating oil (incl. taxes)	Regular gasoline	
		Price (incl. taxes)	Taxes only
(Dollars per Imperial gallon)			
Paris	0.75	2.06	1.23
Stockholm	0.67	1.77	0.92
London	0.67	1.48	0.80
Washington	0.58	0.81	0.21
Ottawa	0.52	0.86	0.34

SOURCE Data from the Department of Energy, Mines and Resources.

years ago (Chart 1-5). On the supply side, estimates prepared by the Department of Energy, Mines and Resources suggest that oil from inexpensive conventional sources in Canada, which now meets 65 per cent of requirements, will meet only 25 per cent of them by 1990; in the meantime, Canadians will have to turn to more expensive sources, such as oil sands, heavy oils, and as-yet-undeveloped natural gas supplies.

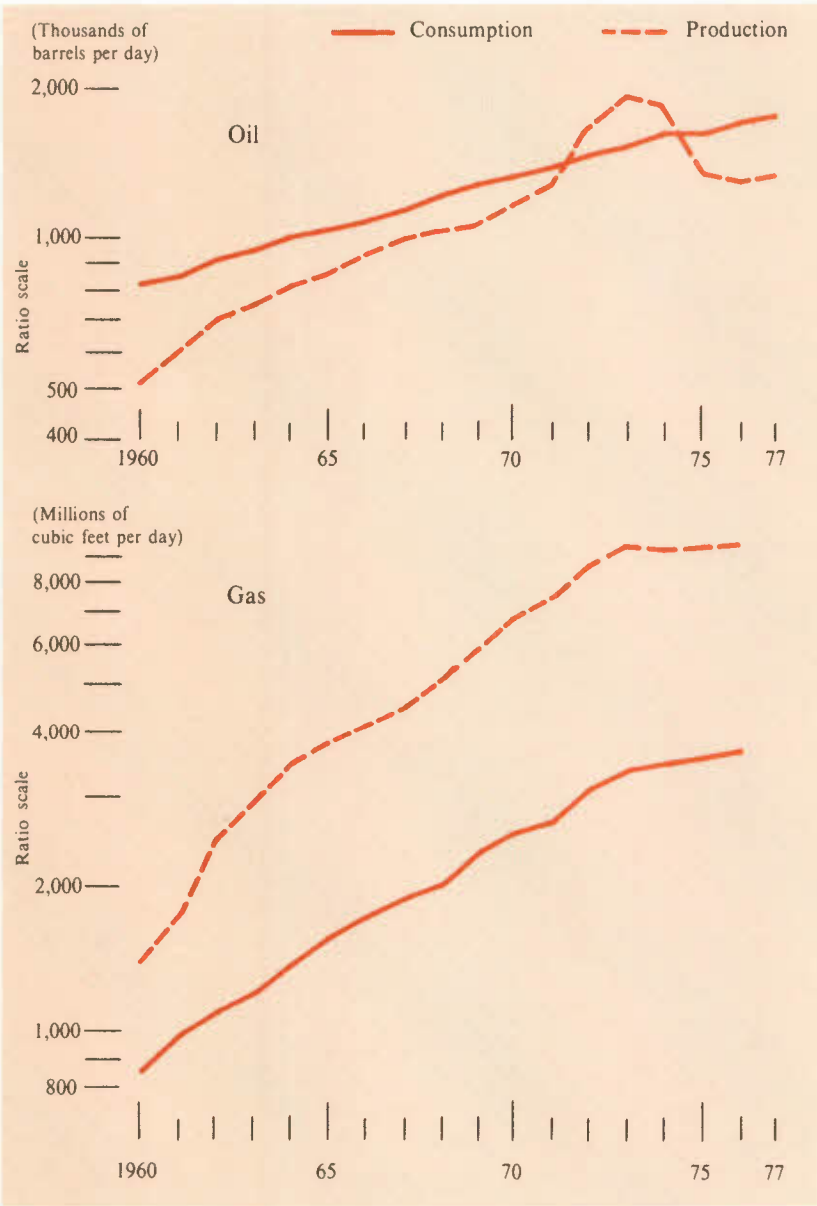
While the prices of most staples tend to rise uniformly across the country, there are differences between cities or regions. This year, the sharpest increases are reported in Regina, Montreal, and St. John's (Table 1-2). As for housing costs, among major cities, Montreal has had the least inflation since 1971. The rise in the housing index this year has been most pronounced in the Prairies.

Despite the continued rise in energy prices, inflation rates are expected to moderate in 1978. The removal of the anti-inflation controls is not likely, in our view, to trigger upward pressures on prices. Indeed, we expect food prices to decelerate and overall domestic prices to adjust to cost increases caused by the depreciation of the Canadian dollar. This view is generally shared by the OECD, which has estimated that, because of the weak demand outlook, annual price increases in major western countries will remain in the 6-to-8 per cent range at least until the middle of 1978. This takes account of the low level of prices for grain and other food staples that will result from this year's bumper wheat crop in North America and the recovery of cereal production in the U.S.S.R.

The years 1976 and 1977 have seen some lowering in unit labour costs and very modest growth in profits per unit of output. However, these improvements have been slower than in earlier recovery periods. Overall corporate profits picked up in the first quarter of 1977 but fell back in the second quarter. The rate of growth in unit labour costs has eased partly through moderation of negotiated wage increases in both the public and

private sectors and partly through direct intervention by the Anti-Inflation Board.

Chart 1-5
Production and Consumption of Oil and Gas,
Canada, 1960-77



SOURCE Data from Statistics Canada, and *Oil Week*, February 14, 1977.

Table 1-2

Change in Consumer Price Index, Canada, January-August 1977

	Year-over-year increase			Average index, January-August 1977		
	All items	Food	Housing	All items	Food	Housing
	(Per cent)			(1971=100)		
St. John's	7.3	6.9	9.3	163.7	191.1	161.2
Halifax	7.2	5.4	9.4	154.3	176.1	150.8
Saint John	7.1	5.9	9.6	157.1	182.2	153.3
Montreal	7.9	7.4	9.0	155.5	180.0	143.3
Toronto	7.2	5.6	9.1	155.1	175.8	150.0
Winnipeg	7.7	5.4	12.0	159.1	177.1	163.9
Regina	9.4	7.6	11.2	156.4	170.0	156.2
Calgary	8.1	5.3	11.5	156.0	168.5	158.0
Vancouver	7.3	5.0	10.5	159.9	179.8	157.4

SOURCE Data from Statistics Canada.

The Labour Market

The rate of expansion of the labour force has been decelerating from a record 4.2 per cent in 1974 and will likely average 2.6 per cent this year. Nevertheless, this figure will represent close to 300,000 individuals; about one-fifth of this number will result from a rise in overall participation rates, and the balance from the increase in the working-age population (Table 1-3). The modest rise in participation rates is consistent with the rather sluggish pace of economic recovery. Despite the slowdown of employment growth, it appears that some persons who postponed joining the labour market last year have entered it during 1977; this presence of previously "discouraged" or "threshold" workers in the labour force has added to an already high unemployment rate.

For this year as a whole, employment is expected to grow by roughly 180,000 individuals — an increase of 1.5 per cent over the 1976 level. The new jobs are concentrated almost entirely in white-collar, service-related activities. Employment in agriculture and manufacturing has actually declined. Since the increase in jobs has failed to match the expansion of the labour force, unemployment has swelled by over 100,000 people, raising the aggregate annual unemployment rate to more than 8 per cent of the labour force and to more than 5 per cent among prime-age males.

Compared with 1961, when unemployment rates were equally severe, the burden of today's unemployment lies less heavily on adult males, whose relative numbers have increased the least, and more on secondary earners — young entrants and women age 25 and over — whose numbers in the labour force have increased the most (Table 1-4).

10 The Economy in 1976 and 1977

Table 1-3

Labour Market Indicators, Canada, 1974-77

	1974	1975	1976	1977 ¹
	(Per cent)			
Increase in working-age population	2.8	2.7	2.4	2.2
Participation rate ²	60.5	61.1	61.1	61.4
Increase in labour force	4.2	3.7	2.5	2.6
Increase in employment	4.4	1.9	2.3	1.5
Unemployment rate	5.3	7.0	7.2	8.0

1 First nine months of 1977 only.

2 Labour force as a proportion of working-age population.

SOURCE Data from Statistics Canada.

Table 1-4

Unemployment, by Age-Sex Group, Canada, 1961 and 1977

	1961		1977 ¹	
	Proportion of total unemployed	Unemployment rate	Proportion of total unemployed	Unemployment rate
	(Per cent)			
Both sexes, 15-24	33.0	10.9	48.1	14.3
Females, 25 and over	6.2	2.5	22.9	7.2
Males, 25 and over	60.8	7.2	29.0	4.9
Total	100.0	7.1	100.0	8.0

1 First nine months of 1977 only.

SOURCE Data from Statistics Canada.

Even during the phase of strong expansion in 1971-74, the economy was not able to absorb fully the inflow of new workers. Moreover, in recent years, it has become clear that higher education is no longer the assured path to preferred incomes, jobs, and status that it once was. On the other hand, in the present economic slowdown, the lack of jobs undoubtedly has prompted some young people to stay in school. Whether, in the long run, they will gain or lose from the additional schooling will likely depend on the pace of economic growth, particularly in those areas where their acquired skills are most useful. Should the relative shortage of jobs persist, it could seriously undermine their confidence and adaptability.

According to the Labour Force Survey, employment growth rates in Newfoundland, Saskatchewan, and Alberta in the first nine months of 1977 were much stronger than the Canadian average. At the same time, the numbers of unemployed in these provinces grew — largely as the result of immigration from other provinces in the case of Alberta. Two provinces — British Columbia and Prince Edward Island — had reasonably healthy

increases in employment and some decline in unemployment rates, whereas Nova Scotia, New Brunswick, and Quebec, with negative or little employment growth, saw unemployment rates jump by over 1.3 percentage points.

Duration of unemployment tends to be longer in provinces with higher unemployment rates, with the average duration ranging from two months in Alberta to more than four months in Newfoundland (Table 1-5). Moreover, in most provinces the likelihood of becoming unemployed is positively correlated with the duration of unemployment, although there are interesting differences. For instance, if one compares British Columbia with Quebec — provinces with higher-than-average unemployment rates in 1977 — workers in British Columbia were more likely to become unemployed than their Quebec counterparts but, on average, they were unemployed for substantially shorter periods. Quebec's unemployment rate was higher than Ontario's by 2.8 percentage points, and its unemployed workers remained jobless an average of 2.3 weeks longer. Both Alberta and Saskatchewan had very low unemployment rates but, because of the rapidity of job turnover, Alberta workers were more likely to become unemployed and also, on average, to regain employment three-and-a-half weeks sooner than those in Saskatchewan. These are aggregate figures, of course, and the incidence and burden of unemployment vary widely between rural and urban labour markets and between different age-sex and occupational groups.

Table 1-5

Duration of Unemployment, Canada, by Province, 1977¹

	Unemployment		
	Average duration	Rate	Probability index ²
	(Weeks)	(Per cent)	
Newfoundland	18.0	15.4	.445
Prince Edward Island	14.6	9.5	.338
Nova Scotia	16.7	10.7	.334
New Brunswick	17.6	13.2	.390
Quebec	16.4	9.8	.312
Ontario	14.1	7.0	.257
Manitoba	11.6	5.9	.264
Saskatchewan	11.7	4.6	.204
Alberta	8.2	4.4	.276
British Columbia	13.2	8.5	.336
Canada	14.8	8.0	.281

1 First eight months of 1977 only.

2 The proportion of the labour force that would have experienced unemployment sometime during the year if no individual had more than one experience and if the period of unemployment were normally distributed around the average.

SOURCE Data from Statistics Canada.

Incomes

Employment opportunities and income are closely related. In 1975, average family incomes barely managed to keep pace with inflation. The average total income for all family units in Canada that year was \$13,805, up 11 per cent over the previous year, matched by a corresponding increase in the cost-of-living index (Table 1-6). Older persons and pensioners clearly suffered decreases in real income as a consequence of high inflation rates. In 1976, despite rising unemployment, the average income for all households jumped to \$15,816. With cost-of-living increases dropping back to 7.5 per cent, this meant real gains of 7 per cent. Young people, two-member families, and residents of British Columbia benefited the most.

Table 1-6

Average Income of All Families and Unattached Individuals, 1975 and 1976

	1975		1976	
	Average income	Rate of increase ¹	Average income	Rate of increase ²
	(Per cent)			
Canadian average	100.0 ³	11.0	100.0 ⁴	14.6
Region				
Atlantic provinces	84.2	14.7	82.8	12.7
Quebec	93.4	11.1	94.0	15.3
Ontario	108.7	10.9	106.8	12.6
Prairie provinces	96.7	9.3	98.4	16.6
British Columbia	103.3	12.2	106.9	18.6
Size of family (persons)				
1	47.8	8.1	47.6	14.0
2	97.6	11.8	100.8	18.4
3	116.8	12.8	119.4	17.1
4	132.6	12.9	130.7	14.4
5 or more	145.6	11.7	142.7	12.3
Age of head (years)				
Less than 25	60.0	13.9	67.4	28.8
25-34	105.9	13.6	104.7	13.3
35-44	128.6	11.4	127.7	13.8
45-54	132.4	13.8	131.2	13.6
55-64	101.5	8.6	104.8	18.3
65 and over	54.6	3.7	53.2	11.7

1 Over 1974 level, calculated in current dollars.

2 Over 1975 level, calculated in current dollars.

3 Average income = \$13,805.

4 Average income = \$15,816.

SOURCE Data from Statistics Canada (Surveys of Consumer Finances).

There has been a narrowing of regional disparities in per capita incomes during the 1970s (Table 1-7), although total farm income has dropped substantially over the past two years. The disparities are even narrower when they are measured in terms of income per employed worker, although the latter measure must be regarded with some caution.² While figures for 1977 are not yet available, slower overall increases of real disposable income per capita suggest that the pace of improvement in family well-being observed in 1976 and earlier years will not be repeated.

Table 1-7

Income per Capita and per Employee,
Canada, by Province, 1971-75

	Increase, 1971-75		Level in current dollars, 1975	
	Income per capita	Income per employee	Income per capita	Income per employee
	(Per cent)			
Newfoundland	83.5	71.4	69	102
Prince Edward Island	85.5	n.a.	69	n.a.
Nova Scotia	73.9	57.3	79	91
New Brunswick	81.0	66.3	77	93
Quebec	74.1	58.6	91	94
Ontario	60.1	47.3	110	103
Manitoba	74.6	62.5	97	96
Saskatchewan	116.5	92.2	102	103
Alberta	78.2	59.9	104	97
British Columbia	67.4	55.8	107	107
Canada	70.0	55.6	100	100

n.a. — not available.

SOURCE Data from Statistics Canada.

Conclusion

Canada's economic recovery from the 1974-75 recession has sputtered, and the consequent combination of high unemployment, idle capacity, and persistent inflationary pressures has slowed growth in individual and

- 2 Both measurements are affected by the size of families in relation to the number of breadwinners. In the Atlantic provinces, the average family unit is larger and the average number of breadwinners in each family is smaller than in other regions. Similarly, according to the 1971 census, only 72 per cent of the family units in British Columbia consisted of two or more persons, compared with 79 per cent in Ontario and 85 per cent in the Atlantic provinces. Moreover, substantial amounts of unemployment insurance and social assistance payments are included in the figures for the poorer provinces. In addition, in those provinces where a significant proportion of the labour force is engaged in farming, fishing, or other forms of self-employment, relating total income to numbers employed tends to inflate the figures per employed worker.

family real incomes. While there has been, and will be, some stimulation from exports, the principal components of aggregate demand — business investment, and consumer and government spending — are now constrained. A high level of transfer payments has helped to cushion the hardship for many people, but basic problems remain. Canadians are becoming aware of the need for some major restructuring within the economy both to render it more internationally competitive and to resolve competing claims for income shares more efficiently than in the past. This is especially true in the areas of investment and plant modernization, and energy supply and conservation, as well as for the enhancement of regional opportunities. The choices confronting governments at all levels are not easy, nor are they helped by today's constitutional uncertainties. The government's anti-inflation strategy called for a unique and complex intrusion into markets and decisions normally reserved for business and organized labour — a controls system that is only now beginning to be dismantled. Nevertheless, if we, as a nation, emerge from this period with a greater sense of realism about what we can and cannot afford and of the limitations of our traditional economic stabilization instruments, the experience may have been worthwhile.

2 The Struggle against Inflation

Among the most important policies affecting the performance of an economy are demand-management policies — namely, monetary and fiscal policies. The importance of these instruments lies in the role they play in increasing, maintaining, or reducing total demand in the economy. Historically, the focus of these policies in Canada has alternated between the problems of unemployment and inflation, with the emphasis shifting with economic fluctuations. Over the postwar period, Canada has typically relied on conventional instruments in formulating its stabilization policy. Only recently has major direct governmental intervention in the process of wage and price determination taken place through the implementation of an incomes policy.¹

Developments to 1975

As Canada entered the 1970s, concern about rising prices prompted Canadian policymakers to implement very restrictive monetary and fiscal policies. The pursuit of these policies brought about strong upward pressures on the then-fixed exchange value of the Canadian dollar, leading to the adoption of a floating rate in June 1970. By the end of 1970, Canada had achieved the major objective of its restrictive policies — namely, substantial deceleration of its inflation rate, resulting from both the slowdown in economic activity and appreciation of the exchange rate of the Canadian dollar. There was a cost attached to this achievement, however, as unemployment rose substantially during that period.

Mounting concern about rapidly rising levels of unemployment, combined with unexpectedly large additions to the labour force, set the stage for a shift towards more expansionary policies. This took the form of strong expansion in monetary aggregates and successive downward adjustments in the bank rate in 1971. The recovery from the 1970 slump

1 A Prices and Incomes Commission and a Food Prices Review Board were established in the late 1960s and early 1970s, but neither agency had the legal power to roll back price and income increases.

was very rapid and, from 1971 to 1973, real GNP expanded at rates exceeding the estimated growth potential of the economy. This rapid growth was stimulated by the simultaneous boom that prevailed in other major industrialized countries in 1972 and 1973.

Signs of overheating, combined with substantial increases in interest rates abroad, led Canadian monetary authorities to raise the bank rate in five consecutive steps in 1973 and three more times in the first half of 1974. Many observers at the time interpreted these adjustments as a shift towards monetary restraint. When assessed against the rate of monetary expansion, however, the stance of monetary policy from 1971 to the end of 1975 appears to have accommodated, rather than curtailed, the growth of government and private spending, except for a relatively brief interval in the second half of 1974 and early 1975. Although inflation was still accelerating in 1974, the main concern of policymakers was to cushion the Canadian economy against the shock of an emerging worldwide recession; this concern was borne out in the federal budget presented in November 1974, which contained tax cuts and investment incentives.

Faced with sharp price increases, extraordinarily high wage settlements in some industries, and heightened militancy in some public-sector labour unions, the federal government — after consultation with the provinces² — announced in the fall of 1975 the implementation of an anti-inflation program. This broad contra-inflationary strategy contained not only recourse to the traditional fiscal and monetary instruments of stabilization, but also the adoption of mandatory price and income controls to be implemented by an Anti-Inflation Board (AIB).

The Controls Program

The AIB exerts direct control over the wages and profit margins of most firms employing 500 or more people; all their employees, unionized or not, are covered. A major duty of the AIB is to review wage and salary increases and either approve them or roll them back to a level determined by the Board. There can be no doubt that the presence of the AIB has resulted in significant moderation of wage demands and, with the passage of time, compensation increases submitted to the Board have moved progressively closer to the guidelines set out in the legislation. The record also suggests that, by imposing constraints on wage costs, the Board has contributed to limiting domestic price increases to levels generally in line with those observed in most other member countries of the Organisation for Economic Co-operation and Development (OECD). Because overall wages

2 In fact, agreements to adhere to the compensation guidelines were signed with eight provinces; Saskatchewan and Quebec established their own restraint programs.

and salaries increased faster than prices, workers continued to achieve real income gains in 1976. The situation has become less favourable in recent months, however, with prices escalating more rapidly than wages.

Wage Controls

On the wage side, from the start of the program until September 1977, the Board reviewed compensation plans covering 3.5 million employees — nearly 100 per cent of the workers subject to the guidelines. About 67 per cent of all compensation plans reported to the Board were at or below the applicable arithmetic guidelines.³ The remaining plans exceeded the guidelines and required a ruling by the AIB. By September 1977, the Board had ruled on some 13,900 cases affecting 1.8 million employees.

The increases allowed by the Board for compensation plans initiated prior to the invocation of the anti-inflation program averaged 14.8 per cent — a figure that reflected the high incidence of historical wage relationships (Table 2-1). While the Board took account of historical wage

Table 2-1

Approval by the Anti-Inflation Board of
Salary Increases Submitted above the Arithmetic Guideline,
by Program Year, to September 23, 1977

Effective date of compensation increase	Number of employees ¹	Average		
		Increases submitted	Arithmetic guideline	Increases allowed
		(Per cent)		
Pre-program				
Before Oct. 14, 1975	180,992	17.3	10.4	14.8
Program year I				
Oct. 14, 1975 to Oct. 13, 1976	1,390,100	12.1	9.1	10.1
Program year II				
Oct. 14, 1976 to Oct. 13, 1977	922,883	8.6	7.3	7.5
Program year III				
Oct. 14, 1977 to Oct. 13, 1978	159,009	6.2	5.7	5.7

¹ A number of wage plans cover a period of more than one year; as a result, there is a certain amount of double counting in the numbers of employees covered in each program year.

SOURCE Data supplied by the Anti-Inflation Board.

- ³ The arithmetic guidelines are the sum of three elements: a "basic protection factor," which was set at 8 per cent for 1976 and 6 per cent for 1977; a "national productivity factor" of 2 per cent; and an "experience adjustment factor," which may vary between -2 and 2 per cent, depending on a group's experience relative to the rise in the consumer price index over the past two or three years.

relationships where they existed, it did not always restore them fully. Special consideration was also required in several cases where previous wage plans had been signed before January 1, 1974.

The rate of wage increases in major collective agreements has dropped sharply in the past two years. Although negotiated wage gains in 1976 continued to be higher in the public sector than in the private sector, the gap has narrowed considerably (Table 2-2). Since the beginning of 1977, the trend has been towards some further moderation.

Table 2-2

Increase in Base Wage Rates over Life of Collective Agreements, 1973-77

	1973	1974	1975	1976	1977	
					Q1	Q2
					(Per cent)	
Private sector	10.1	14.4	14.4	9.4		
Public sector	10.6	14.8	18.6	11.1		
Federal	12.3	11.3	14.3	11.5		
Provincial	10.1	15.1	20.0	11.3		
Municipal	9.0	12.6	17.8	10.6		
Education; health and welfare	10.2	17.8	21.3	10.7		
All sectors ¹	10.4	14.6	17.0	10.5	8.6	8.0

¹ Bargaining units of 500 employees or more in all industries, except construction.

SOURCE: Data from Labour Canada.

Price and Profit Controls

The Anti-Inflation Board's basic approach to price and profit controls has been to induce large firms to restrict price increases by permitting them to pass on to consumers only the additional costs actually incurred and to hold down profit margins below those earned during a base period specified in the Board's regulation. Profit margins for the large firms that submitted reports during their first compliance period under the program⁴ averaged 66 per cent of the target margin for all industries combined. About 45 per cent of firms achieved profit margins that could be considered close to the permissible margins. Preliminary indications for the second compliance period (fiscal year ending after October 14, 1976) suggest that the actual margins will again be below the average target margins.

The Anti-Inflation Act also gave the AIB the power to request companies to provide advance notification of important price changes. In 1976, about 1,300 applications for price increases were filed with the Board; as most of the price prenotifications were consistent with the guidelines, the increases were allowed. They applied to sales of close to \$30 billion and

⁴ The first compliance period was the fiscal year of suppliers that ended after October 14, 1975.

averaged 6.8 per cent. Since the beginning of 1977, prenotified price increases have hovered around 4 per cent. To date, the Board has rolled back fewer than 25 proposed price increases.

Assessment of the Program

It is probably impossible to make a clear-cut judgment on the overall benefits and costs of the federal government's anti-inflation program; generally, however, the following observations can be made.

Controls are best used as a relatively temporary "shock" measure to curb self-realizing rounds of inflationary pressures and expectations arising from a sudden burst of wage or price increases. Most control schemes impose very stringent wage and price guidelines immediately, with gradual relaxation later. In Canada, the reverse course has been followed; controls were applied fairly generously initially, with provision for wage and price catch-ups where appropriate, and they became more stringent over the course of the following years.

Controls have made a more direct and visible impact on wage settlements than on prices and profits. This is not necessarily a criticism of the controls. Annual increases in wage levels and unit labour costs were originally far out of line with productivity gains. Profits have grown moderately because of generally sluggish business conditions and idle capacity, and not because of the application of AIB penalties, except in a few cases where reported excess profits were redistributed to consumers.

Despite the publicly expressed hostility of labour unions and business organizations towards the anti-inflation program, at present the controls still command the support of the majority of Canadians. Such measures have been used by most member countries of the OECD at one time or another, with varied effectiveness. Without specifying the form that controls should take, the OECD recognizes them as a legitimate economic option for governments.

Although a few commentators have argued that the main effect of controls has been to distort the wage structure so that it fails to reflect normal market forces, we see little evidence of this. Rather, we see the controls as having helped to prevent certain groups that exercise market power — often in the public sector — from successfully pressing exorbitant demands, which burden consumers with either higher prices or taxes.

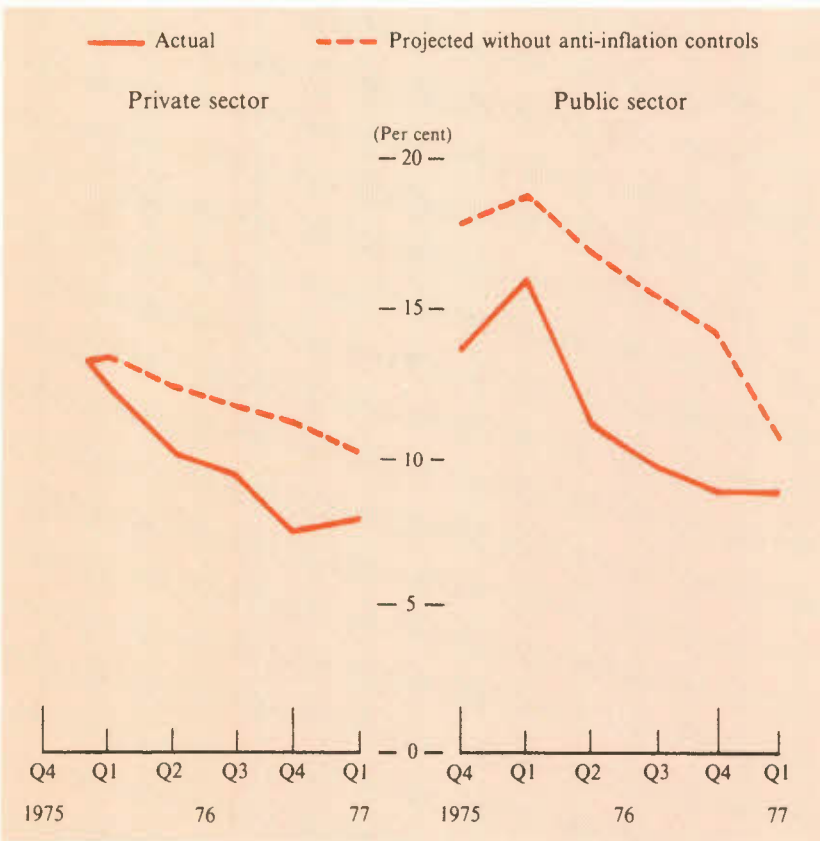
Indeed, a study undertaken for the Council⁵ compares what actually happened to wage settlements under AIB controls with what would

5 J.-M. Cousineau and R. Lacroix, "L'impact de la politique canadienne de contrôle des prix et des revenus sur les ententes salariales," Economic Council of Canada Discussion Paper 95, Ottawa, 1977. A study done by the OECD Secretariat reached similar conclusions as far as wages are concerned. See OECD Economic Surveys, *Canada* (Paris: OECD, 1977), pp. 39-40.

probably have occurred on the basis of past negotiations and economic trends (Chart 2-1). The authors conclude that the average annual increase in the base rate in major collective agreements would have been 1.7 percentage points higher in the private sector and 4.3 percentage points higher in the public sector had the anti-inflation guidelines not been in force. On the whole, given the considerable variation in the number and nature of contracts negotiated in each quarter, the impact of the AIB was most pronounced in the public-sector agreements settled in mid-1976 and the private-sector agreements settled in the last quarter of 1976.

Chart 2-1

Actual and Projected Average Increase in
Base Wage Rates in Major Collective Agreements,
Fourth Quarter 1975 to First Quarter 1977



SOURCE J.-M. Cousineau and R. Lacroix, "L'impact de la politique canadienne de contrôle des prix et des revenus sur les ententes salariales," Economic Council of Canada Discussion Paper 95, Ottawa 1977.

A Step Beyond . . .

In his Economic and Fiscal Statement of October 1977, the federal Minister of Finance announced that the wage and price control program will be phased out beginning in April 1978. Wages negotiated prior to the April deadline will be contained to the AIB basic guideline of 6 per cent for the third year of the program. After that date, negotiations for wage agreements will not be subjected to the AIB regulations. As for price and profit controls, businesses will be released from guidelines in their fiscal years beginning after that date. An agency will also be set up to monitor price and cost developments after the lifting of controls. In the period leading to the termination of controls, a series of discussions will have to take place between business, labour, and government. In particular, the issue regarding the establishment of an economic and social consultative body will have to be resolved.

Monetary Policy

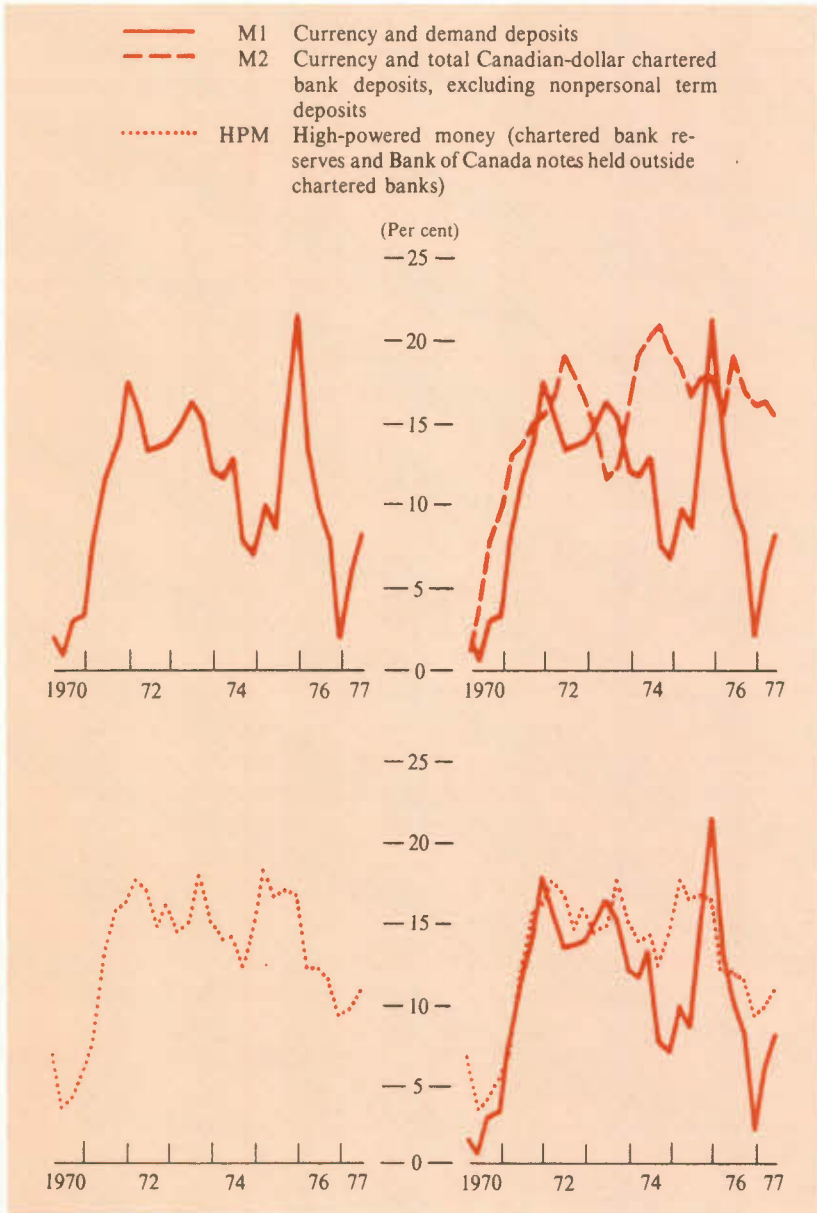
In the fall of 1975, the Bank of Canada adopted a major change in its approach to monetary policy, embracing some principles of the protagonists of the monetarist approach to stabilization policy. These theorists have long asserted that inflation is simply a monetary phenomenon and that the rate of inflation is directly related to increases in the money supply. For instance, if, as a result of collective bargaining, wage rates exhibit a sharp increase, this upsurge initially brings about a relative price change, in the sense that labour income increases at the expense of profit shares. If the central bank allows the money supply to adjust upwards to maintain a full-employment level of demand at the higher wage level, however, corporations are then able to maintain their profit shares by increasing prices. In the process, what was essentially a relative price change becomes a generalized price increase. In contrast, if the central bank does not permit the money supply to grow, inflation will not be accommodated.

The target growth rate for the narrowly defined money supply — currency plus demand deposits, often referred to as M1 — was adjusted downward to a new range of 8 to 12 per cent in the summer of 1976, from the range of 10 to 15 per cent set in late 1975.⁶ In the ensuing months, the money supply remained constantly below the lower end of the range, and the shortfall was particularly pronounced at the end of the year (Chart 2-2). This led the Bank of Canada to lower the bank rate in four successive steps

6 The target was further lowered to a range of 7 to 11 per cent in early October 1977.

Chart 2-2

Year-over-Year Change in Monetary Aggregates, by Quarter, 1970-77



SOURCE Based on data from the Bank of Canada.

between October 1976 and May 1977, from a level of $9\frac{1}{2}$ per cent to $7\frac{1}{2}$ per cent.

In the recent past, large discrepancies have been observed between the growth rates of various money supply indicators. These diverging patterns have been particularly pronounced when interest rates have been high, making it more costly for depositors to hold non-interest-bearing balances; people have therefore been induced to shift their funds from demand deposits to savings deposits in chartered banks. As a result, the growth rates of the narrowly defined money supply have tended to decelerate while those of M2 — the more broadly defined money supply, which includes interest-bearing deposits — have tended to accelerate. But this phenomenon is only part of the story.

The chartered banks' share of the total market for credit tends to increase during periods of high interest rates. This reflects the fact that banks usually face an increasing demand for loans in times of rising interest rates and respond by offering more attractive interest rates on term deposits to obtain larger inflows of interest-bearing deposits.⁷ The relative share of total deposits held in chartered banks therefore tends to increase in periods of high interest rates, at the expense of other financial institutions. This trend also contributes to an acceleration of M2 as opposed to M1.⁸

The focus placed on control over monetary aggregates implies that the central bank is willing to accept greater flexibility for both interest rates and the exchange rate of the Canadian dollar. The period from the fall of 1975 to the fall of 1976 was characterized by rising interest rates. The widening interest-rate differentials between Canada and the United States, at a time when the public sector's cash requirements were particularly heavy, favoured recourse to external financing and led to an appreciation of the exchange rate of the Canadian dollar. While the timing of the dollar's decline coincided with the November 1976 election in Quebec, for some time it had been generally conceded that the dollar was overvalued in relation to the underlying economic conditions. Thus, in contrast to the previous twelve-month span, the period since the fall of 1976 has been characterized by attempts by the Bank of Canada to accelerate growth in the money supply, declining interest rates, narrowing interest-rate differentials, and a depreciating currency (Chart 2-3).

A point that merits emphasis is that the rate of monetary expansion indicated by the target range of the Bank of Canada is sufficiently high to

7 Bank of Canada, *Annual Report of the Governor* (Ottawa: Bank of Canada, 1977), pp. 23-26.

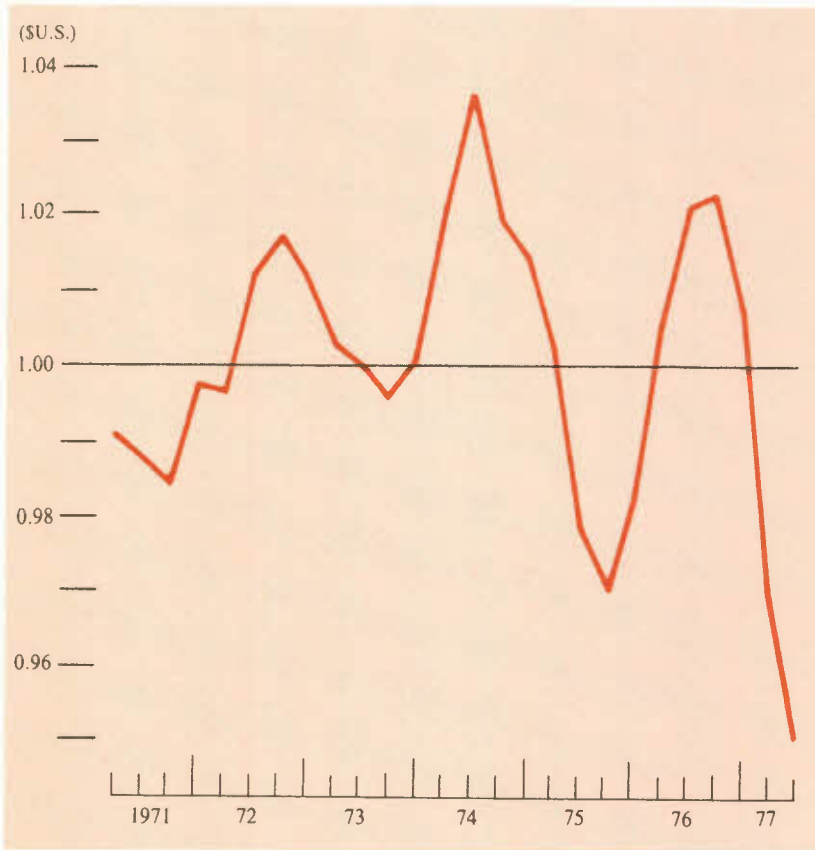
8 In the CANDIDE model simulations developed in Chapter 5, the monetary variable directly subject to policy changes is the monetary base, also called "high-powered money." This indicator includes chartered bank reserves and Bank of Canada notes held outside chartered banks — a measure that in fact reflects the direct obligations of the Bank of Canada. It is assumed that the evolution of the money supply is directly related to the fluctuations in the monetary base.

24 The Struggle against Inflation

accommodate both the expected rise in prices and a moderate gain in production. It is possible, of course, that demand forces will not be strong enough to yield the growth of nominal income permitted by the monetary expansion. In that event, however, interest rates would tend to fall, thus helping to induce a positive response in private demand.

Chart 2-3

Exchange Rate of the Canadian Dollar, by Quarter, 1971-77



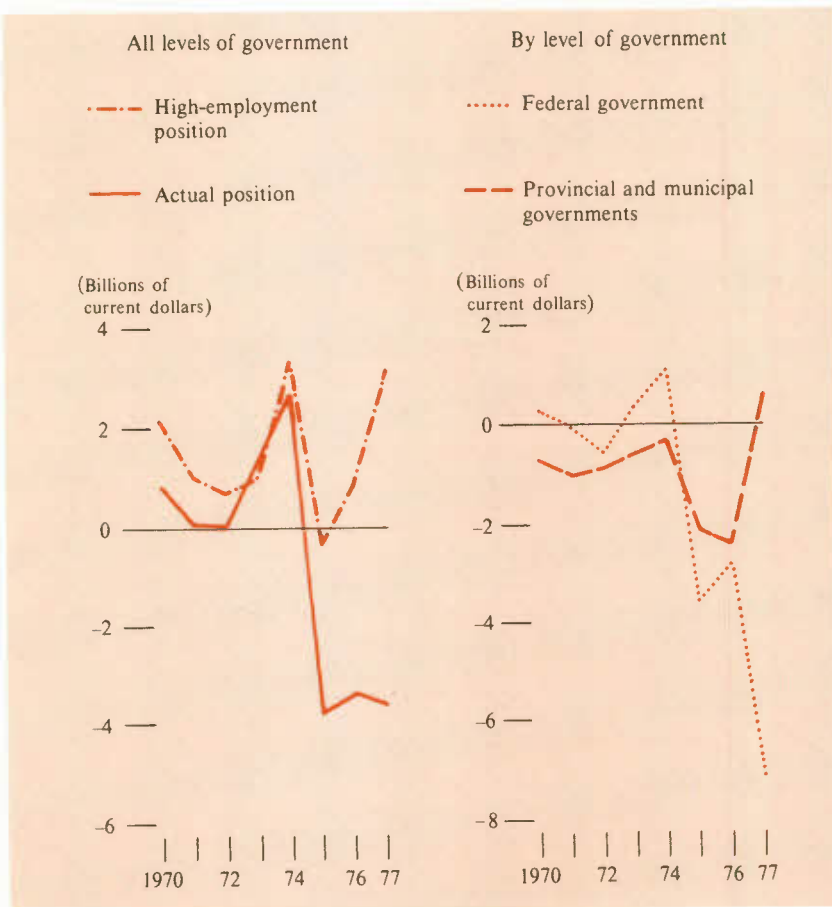
SOURCE Based on data from the Bank of Canada.

Fiscal Policy

The fiscal position of the government sector as a whole, on a National Accounts basis, swung from a surplus of \$2.7 billion in 1974 to deficits of over \$3 billion in both 1975 and 1976 (Chart 2-4). The actual government-sector surplus or deficit in fact reflects two underlying forces — namely, the

budget program itself and the strength of demand in the economy. Thus, in order to assess with more accuracy the economic impact of fiscal policy actions, it is necessary to look at an indicator showing what the fiscal position of the government sector would have been, had the economy been operating at a reasonably high degree of capacity utilization. This measure, called the "high-employment budget position," provides estimates of the revenues that would be generated in a situation of high, steady employment growth.⁹

Chart 2-4

Fiscal Position of Government Sector, 1970-77¹

¹ Data for 1977 are averages for the first two quarters.

SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada.

⁹ More precisely, "high employment" is defined for this purpose as corresponding to an annual average increase of about 3 per cent in employment between 1967 and 1977. The high-employment budget position is calculated on a National Accounts basis and assumes that expenditures remain unchanged.

According to this indicator, the fiscal policy measures adopted over the last three years could be described as restrictive in 1974, expansionary in 1975, and restrictive again in 1976. The expansionary stance of 1975 resulted mainly from the stimulative federal budget brought down in the fall of 1974. On the revenue side, almost all of the provincial budgets of 1976 contained tax increases (in one form or another) while, at the same time, municipal property tax rates were also raised substantially in some cases. Those tax increases were estimated to total about \$1.75 billion between 1975 and 1976,¹⁰ which more than offset the estimated \$1-billion tax cut in 1976 associated with the indexing of the personal income tax system.¹¹ On the expenditure side, spending restraints by federal and provincial governments, as part of the anti-inflation strategy, brought about a slowdown in the growth of public expenditures.

The federal budget speech of March 1977 made it clear that the fight against inflation would continue to receive high priority. Although it contained some measures designed to stimulate business investment, its overall impact has been assessed by most observers as neutral or, at best, only mildly expansionary.¹² At the provincial level, budgets have also tended to focus on restraint, with control of inflation and reduction of deficits as prime goals. In summary, fiscal policy has not exerted any substantial stimulative impact on the economy in 1977.

The measures announced by the federal Minister of Finance in October 1977 are designed to achieve the dual objectives of modestly stimulating the economy in 1978 and minimizing the risk of spurring inflation. The proposed income tax reductions, through their impact on the progression of personal disposable income, are expected to reduce the pressures on wage demands and to bring some stimulus to aggregate demand.

Major revisions to existing federal-provincial fiscal arrangements were negotiated in December 1976; they will alter the mix of government surpluses or deficits in the years ahead, since the federal government has agreed to transfer some financial resources to the provinces. Under the previous arrangement, the federal government paid for half the eligible provincial costs in the area of medical care, hospital, and postsecondary education services. These transfers were "conditional" in the sense that the federal government reimbursed the provinces for a portion of the money spent in those three areas. Under the new system, the transfers are "unconditional," and payments no longer depend on the amounts spent by

10 R. B. Crozier, "Performance and Potential: Perspectives on the Economy," *The Canadian Business Review* 4, no. 2 (Spring 1977), p. 5.

11 C. B. Braithwaite, "The Effects of Indexing on the Built-in Stability of the Canadian Economy," Economic Council of Canada Discussion Paper 65, Ottawa, 1976, p. 26.

12 According to simulations made by the Institute for Policy Analysis of the University of Toronto, the March federal budget might add 0.2 percentage point to the growth of real GNE in 1977. G. V. Jump and T. A. Wilson, "Analysis of the Federal Budget," *Canadian Review* 1, no. 1 (April 1977), pp. 35-38.

the provinces. The value of the transfers is based on the level of the 1975-76 federal payments to the provinces and, from now on, half the federal transfer will be a cash payment, while the other half will be a transfer of tax points. The cash payments will escalate in line with GNP growth, while the tax points will be equalized to the national average yield. Also, the funds transferred from the federal government to the provinces will be adjusted over a five-year period to provide for equality in per capita terms.

Various objectives have been achieved through the new arrangements. For its part, the federal government has succeeded in maintaining the growth of its program contributions in line with the expansion of GNP. Having gained the increased flexibility they sought, the provinces can adjust their delivery systems to provide services at lower cost and will thus have greater incentive to control spending. They can also shift expenditures to programs that command higher priority.

The overall results of the new arrangements will bring a major change in the structure of the public accounts at both levels of government, reducing both federal revenues and expenditures and increasing provincial revenues should the provinces choose to enter tax fields that the central government has abandoned. This, in turn, will increase the need for even better co-ordination of federal-provincial fiscal policies through the already existent federal-provincial meetings of finance ministers. This co-ordination should not be limited to fiscal policies but should also embrace other important policy areas. For instance, a recent study¹³ indicates that debt-management policies could be better co-ordinated. The results suggest that non-federal governments, by financing their debt through foreign capital markets, may alter the outcome of the Bank of Canada's efforts to influence credit conditions over the medium term.

Adherence by the Bank of Canada to monetary targets geared to the achievement of long-run objectives implies that fiscal policy will have to bear the primary burden of stabilizing the economy in the short run. But, even in this area, room for manoeuvre appears to be limited. The central bank's practice of operating with a quantitative target means that any major federal expansionary fiscal action would tend to increase the central government's demand for savings in competition with the provinces and private industry borrowers and would thus exert upward pressure on interest rates.

In its study on regional disparities,¹⁴ the Economic Council concluded that there is considerable scope for the provinces to use fiscal policy more effectively than they have in the past to offset fluctuations in their levels of

13 M. A. Sheik and S. L. Winer, "Anti-Inflation Policy and Nonfederal Behaviour: An Econometric Study of the Canadian Case, Using CANDIDE Model 1.2M," Economic Council of Canada Discussion Paper 58, Ottawa, 1976.

14 Economic Council of Canada, *Living Together: A Study of Regional Disparities* (Ottawa: Supply and Services Canada, 1977).

economic activity. The fact that, as a result of the new federal-provincial fiscal arrangements, the provinces gained greater access to direct taxation powers undoubtedly adds strength to this recommendation, provided that a reasonable degree of federal-provincial co-ordination is achieved and maintained.

Conclusion

The magnitude of the inflationary pressures that plagued the Canadian economy in 1974-75 led policymakers to adopt a strong anti-inflation stance in the fall of 1975. The resulting policy package relied not only on conventional monetary and fiscal instruments but also on the adoption of a program of wage and price controls. Another characteristic of the policy mix applied in the last two years has been the adoption of a gradualist approach to stabilization policy, in which greater stability in the short term has been sought by targeting the expansion of money supply and by limiting the growth of government spending to the expansion of GNP. Along with the current sluggish business conditions, however, high unemployment rates have brought about increased pressures on governments to shift their policy stances and adopt more expansionist measures. Some of the policy options available to governments in that area are examined in a subsequent chapter.

3 Trade Balances and Prospects

Canada's prosperity depends upon its ability to compete in international markets and to maintain its credit-worthiness as an international borrower. Yet, despite some recent cyclical recovery on the trade side, Canada faces an overall weakening associated with low export volumes, strong import competition, higher foreign debt repayments, and increased travel abroad. The decline in Canada's international competitiveness for manufactured goods results from excessive increases in unit costs¹ as well as a lack of energetic entrepreneurial initiative and insufficient modernization of the industrial structure. Developments in both the current and capital accounts² have altered Canada's balance-of-payments profile and have implications for future policy. Indeed, balance-of-payments considerations will, in our view, occupy economic strategists much more during the next five years than they have since 1971.

Problems in the Current Account

Since the worldwide recession of 1974-75, the recovery of the major western industrialized countries has been fragile, and trade volumes have generally been low. A moderate resurgence occurred in 1976 and early 1977, as most countries reconstituted their stocks of oil, raw materials, and other industrial supplies, but it has now fallen off. The Organisation for Economic Co-operation and Development (OECD) has predicted that the growth in the volume of trade to mid-1978 will be less than 7 per cent.³ This represents a significant deceleration from the commercial buoyancy of the early 1970s.

Canada's international trade prospects are considerably less favourable today than, say, a decade ago or at any similar stage in previous economic

1 See Economic Council of Canada, *Thirteenth Annual Review: The Inflation Dilemma* (Ottawa: Supply and Services Canada, 1976), pp. 101-2.

2 Canada's foreign borrowings and international indebtedness are discussed in Chapter 4.

3 Organisation for Economic Co-operation and Development, *OECD Economic Outlook* (Paris: OECD, July 1977), p. 66.

cycles. Traditionally, Canada's merchandise trade balance has been positive, thus offsetting its negative balances for debt repayment, freight, travel, and other services, and leaving the overall balance of payments reasonably viable. In recent years, however, foreign borrowing has increased, services payments have escalated, and merchandise receipts have decelerated. The current account has moved from an annual balance of between $\pm \$1.2$ billion in the late 1960s and early 1970s to an annual deficit of more than \$4 billion in 1975, 1976, and 1977 (Table 3-1). Although the recent depreciation of the Canadian dollar and a reasonably strong recovery in the United States have promoted Canadian export sales, the heavy overhang of debt servicing remains. There is little doubt that the deterioration of the merchandise and debt-servicing accounts is the result of factors that lie deeper than the current cyclical pause and that, in the absence of fundamental changes, the outlook is for continued deficits of widening magnitude.

Table 3-1

Current Account Balance, Selected Years, 1961-77

	1961	1966	1971	1976	1977 ¹
Current account	-928	-1,162	431	-4,187	-4,786
Merchandise trade	173	224	2,563	1,089	2,260
Service transactions	-1,029	-1,438	-2,398	-5,798	-7,452
Travel	-160	-60	-202	-1,191	-1,772
Interest and dividends	-551	-822	-1,141	-2,491	-3,174
Freight and shipping	-82	-65	-12	-173	-148

¹ Estimates based on data for the first half of 1977.

SOURCE Data from Statistics Canada.

Merchandise Trade

The growth rate of Canada's exports depends on the pace of economic activity in the major OECD countries. As weak or strong foreign demand for Canadian exports is transmitted through the economy to consumer spending and domestic investment, these "multiplier" effects influence the pace of domestic economic activity and the level of imports of consumer goods, and machinery and equipment. Relatively strong export sales throughout the late 1960s and early 1970s accelerated the rate of Canadian growth and helped to cushion periodic slumps in domestic investment. The decline in export sales in 1974-75 — about 10 per cent — was a major factor contributing to the recession. Imports remained strong, falling much less than in earlier cyclical downswings. The upshot

was a negative merchandise trade balance in 1975 — the first since 1960. Export volume and prices in 1976 picked up more than those of imports, and the merchandise account showed a \$1.1-billion surplus. Further improvement in the trade balance is likely in 1977. An examination of major components of the merchandise account indicates where current strengths and weaknesses lie (Chart 3-1 and Table 3-2).

Food, feed, beverages, and tobacco

Since 1970, the world price index of foodstuffs has risen faster than that of industrial raw materials or manufactured products. In Canada, agricultural products and fish account for about 11 per cent of the value of all exports. Because wheat and flour constitute 45 per cent of food exports, any development in the total food export group usually reflects trends in wheat exports. In value terms, wheat sales have historically been quite volatile because changes in shipments arose from fluctuations in crop conditions in other major producing countries rather than in Canada. While the level of Canada's grain sales in the 1970s has been higher than in the 1960s, it has failed to keep pace with the growth of world markets. Aggressive selling by the Canadian Wheat Board increased the Canadian market share in 1977, but wet autumn weather has created some uncertainty in meeting export contracts for higher-quality wheat. Large world supplies of wheat and grains continue to hold down prices.

Food imports account for about 7 per cent of the value of total imports. Sugar, coffee, and tea represent about 20 per cent of these purchases, with fruit, vegetables, and dairy products contributing about 30 per cent. Sugar and coffee prices are heavily influenced by supply conditions, and coffee prices in particular rose to record levels in the early months of 1977. This year, too, drought in California and elsewhere in the United States has led to a sharp increase in some imported produce prices.

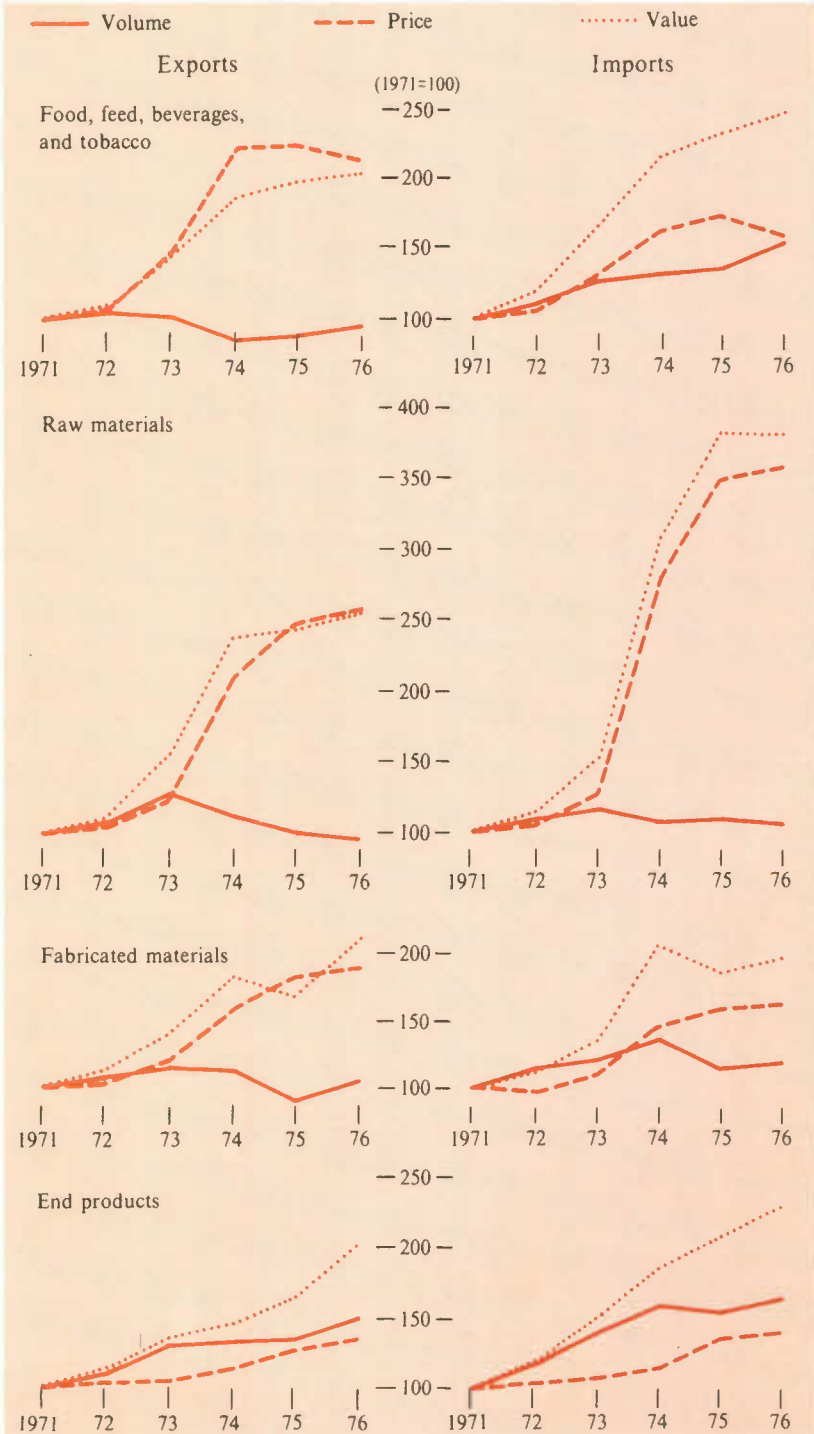
Raw and fabricated materials

Raw materials — petroleum and natural gas, as well as iron, copper, nickel and other ores and concentrates — contribute a little over one-fifth of Canada's export revenue. As with grains, most increases in these export receipts mainly reflect rising prices, since the export volume of inedible raw materials has been declining. Among fabricated materials, forest products such as lumber, pulp, and newsprint account for about 17 per cent of Canada's exports, while chemicals and fertilizers, iron and steel, and nonferrous metals and alloys account for another 16 per cent.

Canadian petroleum and natural gas export sales are regulated by the federal government, which has decided that petroleum exports to the United States will be phased out by the early 1980s. Existing and new natural gas commitments have been one of the elements of the negotiations on the Foothills pipeline between the two countries. Canada is now a net

Chart 3-1

Indexes of Export and Import Volume, Price, and Value, Selected Goods, 1971-76



SOURCE Based on data from Statistics Canada.

Table 3-2

Trade Balance, Selected Goods and Selected Years, 1971-76

	1971	1973	1975	1976
	(Billions of dollars)			
Food, feed, beverages, and tobacco	.93	1.17	1.41	1.34
Raw materials	1.94	3.01	2.86	3.17
Petroleum	.25	.54	-.25	-.98
Natural gas	.24	.34	1.08	1.61
Fabricated materials	2.66	3.94	3.90	5.93
Manufactured end products (excluding automobiles)	-3.54	-5.50	-8.11	-8.91
Automobiles and automotive products	-.10	-.91	-2.12	-1.31
Total merchandise trade	2.56	2.73	-.64	1.13

SOURCE Data from Statistics Canada.

importer of crude petroleum and, although higher prices and other conservation measures should help to restrain somewhat the deteriorating deficit on the energy account, the medium-term future does not look bright. If the Sarnia-Montreal oil pipeline is extended to Quebec City by 1980 and to Halifax by 1982, as has been suggested, it could bring a substantial reduction in crude imports.

Sales of ores and fabricated industrial materials rise and fall in direct response to U.S. industrial activity. The United States continues to depend heavily on nickel, zinc, iron, columbium, tungsten, cobalt, and titanium imported from Canada. Among nonferrous metals, copper alone accounts for about one-quarter of export receipts. The volume of copper sales has been fairly stable since 1972. Heightened competition and the sluggish industrial recovery in most western nations have, however, resulted in relatively depressed copper prices compared with the levels reached three years ago.

Lumber exports depend largely on housebuilding activity in the United States, and the quicker pace of the U.S. recovery in 1976 and 1977 has resulted in a substantial increase in lumber sales to that country. Although prolonged strikes hurt pulp and paper exports in 1975, the volume of exports to the United States recovered in 1976, and it continues to grow at a moderately healthy rate, despite greater competition from new production facilities in the southern states. The export volumes of chemicals and fertilizers have fluctuated in line with cyclical developments in foreign industrial production; price increases have markedly raised the value of these exports.

End products

Another one-third of Canada's export earnings comes from the sale of end products, with motor vehicles and parts representing about 65 per cent of these exports. With the strengthening of U.S. demand in 1976 and 1977,

the volume of automotive exports has recovered, but underlying problems remain. The shift in consumer preferences to small cars, while initially favourable to several lines produced in Canada, has recently tended to favour foreign-built vehicles.

Imports of automotive products generally follow cyclical swings in Canadian demand. Auto parts account for a very large share of these imports and their purchases are closely related to Canada's domestic and export sales of automobiles and trucks. As automobile demand increases in the United States, the demand for parts increases in this country. In 1977, Canada will have an overall net deficit of about \$1.5 billion in automotive trade with the United States.

Hampered by rising costs, the export volume of manufactured goods — excluding automobiles and parts — has increased only marginally in recent years. Imports of industrial machinery have followed the growth of total investment in machinery and equipment. Limited capital spending in Canada has kept the volume of these imports quite low during the past three years.

In the field of manufactured consumer goods, the net trade balance deteriorated in 1976. Whereas import prices for many consumer products have been fairly stable, the prices for the same goods produced domestically have increased. In 1976, there was a 22 per cent increase in the import volume of manufactured consumer goods. This year, with the depreciation of the Canadian dollar, the volume increase is estimated to be less than 10 per cent. In all, imported manufactured goods other than automobiles account for more than one-quarter of the consumption expenditures of Canadians.

The deficit on manufactured goods is now about \$10 billion. It is true that many Canadian manufacturers have been able to obtain higher rates of productivity growth than have their U.S. counterparts, but productivity levels in most Canadian manufacturing activities are still well below those in the United States, and unit costs have risen much more rapidly in this country. A key factor has been the cost of capital and the virtual elimination of U.S./Canada wage differentials in manufacturing. Indeed, wages in some Canadian industries are now considerably higher than in competing firms in the United States.

Services

The services deficit has grown for several reasons. Outflows on the travel account alone accounted for 20 per cent of the deficit in 1976. While the travel deficit averaged about \$250 million a year in the late 1960s and early 1970s, it jumped to \$1,191 million in 1976; it is expected to approach \$2 billion this year. Canada continues to attract visitors

from outside North America, but the problem is rooted in bilateral travel with the United States. Whereas Canadians are strongly attracted to the United States, the number of U.S. tourists coming to Canada has been declining for three consecutive years. In 1976, for the first time, more Canadians visited the United States than vice versa. Some reasons for the decline in U.S. travel to Canada were unique to that year — for example, the bicentennial celebrations in the United States and the disruption of airline traffic in Canada. Other reasons are more basic, however. For Americans, traveling in Canada is no longer as inexpensive as traveling at home: despite the depreciation of the Canadian dollar, high prices continue to discourage foreign spending in this country. Canadians, by contrast, are traveling more than in the past. Increasingly, they are taking second vacations or “mid-winter breaks” outside the country — and, inevitably, to the south.

Large-scale borrowings abroad in the form of debt financing have, of course, increased interest payments, and these contribute negatively to the current account of the balance of payments. Annual interest payments averaged about \$150 million in the 1950s and about \$390 million in the 1960s, with fairly regular increases. But, as foreign portfolio investments accelerated, so did these payments. This year, interest payments alone will exceed \$3 billion. The deficit of the freight and shipping component of the service account has similarly experienced a marked increase.

The Impact of the Exchange Rate

It has been contended that “the prospect of developing an ‘industrial strategy’ which would transform Canada from its historical role as a producer of resource-based crude and semi-fabricated materials to a leader in the production of more highly developed and technologically advanced manufacturing goods received a severe setback as a result of the appreciation of the exchange rate in the 1970s.”⁴ According to this view, the restrictive monetary and fiscal initiatives undertaken in 1969, the rapid escalation of export receipts during the commodity price boom of 1972-73, and the high levels of foreign borrowings that followed, all had the effect of maintaining the value of the dollar at a level out of tune with Canada’s comparative industrial productivity and costs.

For this reason, there has been considerable support for depreciation of the exchange rate as a corrective for Canada’s currently weak position on foreign markets. The 1961-62 devaluation had, after all, helped Canada’s position in the 1960s as the current account balance reversed from a deficit

4 Robert S. Crozier, “Canada’s Balance of Payments: Heading for a Record Deficit,” *The Canadian Business Review* 2, no. 3 (Summer 1975), p. 55.

of \$1.2 billion in 1960 to a surplus of \$1.1 billion in 1970. There were of course, factors other than depreciation that improved Canada's trade balances — the automotive agreement, defence sharing agreements, the general trade stimulus arising from the Kennedy Round tariff reductions, and buoyant wheat sales.

The recent downward slide of the Canadian dollar has contributed to domestic price increases, but it has also provided Canadian import-competing firms with the equivalent of a 10 per cent across-the-board tariff increase. On the other hand, Canada tends to be a price-taker for many of its primary exports; hence it is not at all clear that sales volumes will be measurably enhanced by the depreciation of the dollar. While it has brought some temporary relief to Canadian manufacturers, the longer-run benefits of depreciation are not guaranteed. Other fundamental initiatives — greater control over costs, wage restraint, plant modernization, and more vigorous promotion of export sales and domestic tourism — will be necessary to improve Canada's competitive position.

Canada's Trade Prospects

It will not be easy to improve Canada's trade balance. The trend towards cartels and organized power blocs in international trading relations, for example, is growing — not only in oil but also in many other commodities. New entrants are challenging us in some international markets, and Canadian nickel production in particular is well below capacity. Raw materials and semiprocessed goods, such as copper and newsprint, are also being exported by more countries. To cite a recent federal study of Canada's international position in mineral trading:

A general proliferation of state trading, and the degree to which exports are covered by contractual agreements (IBA, CIPEC, Lomé Convention), limit the size of the market for Canadian minerals.

A system of trading preferences and concessions is being extended to resource-producing developing countries, causing an erosion of Canada's comparative advantage in the mineral resource sector.⁵

Similar developments are also taking place in the area of consumer goods, with South Korea and Taiwan following the manufacturing initiatives of Japan and other low-cost trading nations. And, of course, Canada's net deficit for crude petroleum is mounting.

⁵ Canada, Department of Energy, Mines and Resources, "Canadian Minerals and International Economic Interdependence," Mineral Bulletin MR 162, Ottawa, 1976, p. 38. IBA and CIPEC stand for International Bauxite Association and Conseil Intergouvernemental des Pays Exportateurs de Cuivre, respectively.

The Spectre of Protectionism

In view of the many factors that have depressed world trade and adversely affected the international payments system, efforts have been made to take some new initiatives in world trading relations through a strengthening of the General Agreement on Tariffs and Trade (GATT). The Tokyo round of GATT negotiations has been proceeding for four years now, although the timetable has been delayed several times. In addition to reduced tariffs and nontariff trade barriers, the subjects discussed have included safeguard rules governing "disruptive" imports, the trade needs of developing countries, and access to raw materials by importing nations.

The quadrupling of oil prices has created a current-account drain in both industrial countries and non-oil-producing nations of the developing world. Although the world's capital markets have been equal to the task of recycling surplus petrodollars so far, serious imbalances and tensions have built up among these countries in matters of trade and payments. For many developing countries, the problem has been rendered more acute by the slow recovery in the industrial western countries after the 1974-75 recession and the consequent rise in protectionist sentiment to safeguard domestic employment.

Most western governments have attempted to buttress one another's commitments to freer trade and, from 1974 to 1977, it was agreed at the OECD ministerial meetings to hold the line against protectionism.⁶ In recognition of the third world's legitimate trade aspirations, however, Canada and other countries have agreed to provide unilateral tariff preferences under the General System of Preferences (GSP) for a range of manufactured goods exported from developing countries and to foster such domestic industrial adjustments as would be necessary to make room for this trade. Economic conditions, however, have been such that most countries have hedged the GSP concessions with some combination of nontariff barriers, exceptions, and safeguard provisions allowing them to withdraw preferences if they become too onerous.

Efforts to liberalize trade through GATT have always been hampered by a strong protectionist sentiment. On balance, agricultural trade has been liberalized much less than trade in industrial products. Moreover, the use of such nontariff barriers to trade as discriminatory government purchasing, rigged specifications and standards, and special currency arrangements⁷ has not been regulated well under GATT rules. Furthermore, under the aegis of various multilateral or bilateral understandings, the expansion of world trade in low-cost products has been restrained.

6 See the OECD communiqué on the meetings of June 23 and 24, 1977. Concern about protectionist pressures has led to the creation of various prestigious bodies such as the Williams Commission in the United States and the OECD High Level Group.

7 For example, the "green" exchange rates and monetary compensation amounts for farm transactions used in the European Economic Community.

The concept of "fair trade" is one of the basic tenets of the GATT philosophy. Safeguard provisions, such as the right to counter disruptive dumping or to impose countervailing duties against export subsidies, are intended to encourage genuine reciprocity in reducing import barriers. The idea of "fair trade" is difficult to define, however, and, in some cases, imports are restrained by nontariff barriers not so much because they are "unfair" according to recognized international criteria but rather because they impinge on sales and employment in certain sensitive domestic industries — the garment and textile, shoe, leather goods, and electronics industries in Canada, for example. One aim of current GATT negotiations is to achieve better control of nontariff barriers while improving the safeguard provisions of the agreement:

It is not exactly agreeable, when one is about to enter into negotiations on the liberalization of trade, to have to contemplate measures to permit the re-introduction of tariffs and nontariff barriers. Nevertheless, a further large step in the direction of freer trade does seem to require that there should be a possibility of protecting, temporarily, domestic industries and their workers if these are seriously menaced by imports. Indeed, it is only realistic to recognize that . . . an effective safeguard clause should exist. It can provide a useful guarantee of stability . . . by preventing unjustified re-imposition of trade barriers.⁸

Despite the various high-level and summit pronouncements against backsliding, the International Monetary Fund (IMF) recently observed that, "by early 1977, it was apparent that there had been an interruption to the reduction of protectionism that had characterized the commercial policy of the industrial countries over the postwar period."⁹ The IMF also noted that selective measures to restrict imports were increasingly supported by negotiation of export-restraint agreements, which have been used in some cases to control trade between several of the industrial countries themselves; among OECD countries, Japan has been a major target. The thrust of these agreements has not been entirely negative: some liberalization has occurred, but most of the arrangements have been protectionist.

Canada, too, has imposed selective import controls for employment reasons. In April 1976, for example, global import quotas on acrylic worsted yarn within a certain price range were imposed for three years. Later, a three-year global quota was imposed on low-cost work gloves. Export restraints on winter outerwear were negotiated with Taiwan, Hong

8 Olivier Long, "The Forthcoming Multilateral Trade Negotiations," Press Release GATT/1118, 8 February 1973. Long went on to say: "An agreement on safeguard provisions that can be applied in cases of real difficulty should, in fact, be viewed as a necessary corollary of completely successful multilateral trade negotiations."

9 International Monetary Fund, *28th Annual Report on Exchange Restrictions* (Washington: IMF, 1977), p. 5. Nonindustrial countries have also increased their import restrictions. In the industrial countries, such restraints were imposed primarily on a selective basis for employment reasons, rather than on an across-the-board basis.

Kong, South Korea, and the Philippines. Import licences for worsted fabric were required, for surveillance purposes, for imports from all but eight industrial countries. Imports of certain clothing items in 1977 were limited to the 1975 level. And quotas were imposed for 1977 on imports of beef and veal from the United States, Australia, and New Zealand. While nontariff trade barriers are difficult to measure — or sometimes even to identify, as in the case of provincial purchasing policies — it appears that Canada resorts to them less than most other industrial countries.¹⁰

The Current GATT Negotiations

A number of proposals for tariff-cutting procedures have been tabled for discussion in the current round of GATT negotiations. One proposal from the United States would, in effect, reduce the level of existing tariffs by between 55 and 60 per cent, with few exceptions. The U.S. government was given authority to bargain for reductions of up to 60 per cent, with the option of removing entirely those duties which are now below 5 per cent. This authority expires in 1980, thus setting a deadline for conclusion of the overall negotiations by 1979. Canada has proposed, and GATT has accepted, the concept of sector trade bargaining as a negotiating technique. This would eliminate, or at least greatly reduce and permit effective monitoring of, all trade barriers affecting a particular sector. The European Economic Community (EEC) has placed emphasis on tariff harmonization — that is, the leveling-down of high tariffs to a common ceiling. Average tariffs on dutiable imports are generally lower in the EEC than in the United States, Japan, and Canada (Table 3-3). The common tariff of the EEC is, in effect, a harmonization of the former tariffs of its member countries. The EEC Commission has a mandate to negotiate tariff cuts in the range of 25 to 50 per cent, emphasizing the principle of harmonization. Although other tariff proposals have been submitted to the GATT negotiators, it seems likely that the positions of the United States and the EEC will heavily influence the general formula that is finally agreed upon.

The issue of reduction and control of nontariff trade barriers is also before GATT. A working party has been established to negotiate improvements in government procurement practices that impede international trade and to clarify and specify the safeguard rules.

A number of moves in favour of the exports of developing countries have been made. Some seventy developing countries are participating in the current negotiations. Canada, a number of European countries (including

10 See Economic Council of Canada, *Looking Outward: A New Trade Strategy for Canada* (Ottawa: Information Canada, 1975), pp. 9-24; 139-52.

Table 3-3

Average Tariffs on Selected Imports, Major Industrial Countries, 1977

	Average tariff level ¹	
	Total imports (including duty-free)	Dutiable imports
	(Per cent)	
Raw materials		
EEC	0.8	3.6
United States	3.6	6.8
Canada	1.3	8.8
Japan	4.5	9.4
Partly manufactured goods		
EEC	7.7	9.5
United States	8.1	9.8
Canada	8.2	13.1
Japan	8.5	10.0
Manufactured goods		
EEC	8.9	9.2
United States	9.6	10.1
Canada	9.2	15.1
Japan	11.5	11.8
All imports		
EEC	6.6	9.0
United States	8.1	9.5
Canada	7.6	14.3
Japan	8.9	11.0

¹ A simple average of the percentage figures actually calculated, using each of four methods of weighting the volumes and value of internationally traded goods.

SOURCE: General Agreement on Tariffs and Trade, *Basic Documentation for the Tariff Study* (Geneva: GATT, 1974).

the EEC members), Australia, and New Zealand have agreed to implement tariff concessions on several tropical products. Other developed countries are expected to follow suit in due course. Some industrial countries, including Canada, have been granting general preference treatment to a growing number of developing countries. These steps have been cautious, conditioned by how far or how fast each government is prepared to promote adjustment by the domestic labour-intensive industries that bear the competitive burden of increased low-cost imports. Although this issue is often posed in terms of developing countries, it is also of interest to other industrialized countries—such as Italy, Spain, and Japan—that export standardized manufactured products as opposed to high-technology goods.

Canada's approach to the negotiations has not been widely publicized, although many businessmen in this country are undoubtedly interested in the outcome. The main target of Canadian initiatives will be the U.S. market. A chief concern is to have U.S. tariffs lowered and other discrim-

inations removed on semiprocessed and finished manufactured goods that are competitive, thereby permitting further processing content in Canadian exports. Among other things, Canada would like the United States to eliminate many duties that are now at or below 5 per cent and, specifically, it would like to negotiate more favourable access to trade in nonferrous metals and forest products.

As for nontariff barriers, Canada's aims include codes to limit trade distortions arising from product standards, as well as rules for government purchasing practices, such as those for aircraft and heavy electrical equipment. In the face of falling grain prices, Canada has supported arrangements to achieve more orderly grain marketing as well as efforts to stabilize prices and to build an international grain reserve. As for reforming GATT, Canada wishes to see the adoption of more precise safeguard rules, including the monitoring of export subsidies and provision for quicker, objective decisions on trade disputes and complaints. For many of these goals, there is common ground with the United States and other countries; there is also the prospect of very hard bargaining.

The key to successful overall bargaining will undoubtedly be compromise and reciprocity. Despite the difficulties, it is probable that GATT member countries will conclude an arrangement to reduce trade barriers and reform a number of GATT operational rules. Although the scope of such arrangements is difficult to predict, the governments concerned are aware of the great danger, in terms of high economic cost, of failing to reach substantial accommodation.

Freer Trade and Industrial Adaptation

The Canadian government has been reasonably forthright in describing its export objectives, but its conditional offers to reduce trade barriers have not been as fully described in public. The element that appears to be lacking is a clear plan to foster the adaptation of Canadian industry to the trade concessions to which Canada would agree. Although various adjustment schemes exist, they are neither comprehensive nor extensive. From the viewpoint of Canadians in general, the long-run opportunities to be gained from reduced trade barriers and increased specialization, productivity, and real income are enormous. From the viewpoint of firms, labour groups, and communities that must face increased competition, however, the overall gains may appear irrelevant or unwarranted unless the ensuing hardship and economic loss are somehow offset or compensated and unless the new opportunities are quite concrete.

It is worth repeating that any increased protectionism by itself would very likely be self-defeating. Canada would find itself subsidizing its weakly competitive industries at the expense of its more competitive, largely export-oriented sectors. Consumers, as well as firms, labour groups, and

communities that rely on competitive industries, would be the victims of policies that raised costs and inhibited the accessibility of Canadian products to large markets. The realities of the economic situation dictate that efforts for stronger participation in an open world economy must be accompanied by effective policies for industrial adaptation.

In a report published two years ago,¹¹ we concluded that, during a period of relative buoyancy, the economy as a whole should be able to absorb or offset transitional employment problems created by the move to freer trade. We remain convinced of this. In recent years, however, the Canadian economy has performed poorly with respect to growth and employment objectives. In part, this reflects a substantial decline in the competitiveness of Canadian industry in international trade on both the export and import sides — a decline that goes beyond the normal cyclical malaise associated with a world recession. The need for Canadian industry to readjust along the lines of its most productive endeavours is now greater than ever, and it will persist whether the degree of trade liberalization agreed upon by GATT is large or small.

It must be noted, however, that the difficulties of adjustment have also increased. The problem of limited resource mobility in some industries must be recognized as a special factor requiring innovative measures to overcome it in the long run. The textile and garment trades, for instance, employ many married women who cannot simply pick up and move to jobs elsewhere. Workers with strong family and cultural affiliations, such as those in smaller Quebec centres, are unlikely to want to migrate even if there are advantageous job opportunities elsewhere. Efforts to avoid, or at least ameliorate, problems of this type are surely desirable.

A discussion of the problems associated with the rearranging of Canada's industrial structure runs the risk of leaving the impression that only problems exist. Canadian industries that suffer from elements of comparative disadvantage would not necessarily disappear under freer trade arrangements, although their relative size in the economy would be reduced. Encouragement by the federal government has already steered some industries — such as food processing — away from specialized lines that would bring them the severest competition. There are, however, industries with a clear comparative disadvantage in Canada — labour-intensive industries that even now are marked by lower-than-average wages and productivity and that would become even worse off under conditions of freer trade. Even after years of special protective measures and incentives to rationalize and modernize, the problems of orderly contraction will be difficult. In virtually all these enterprises, the value added per employee is well below the national average for manufacturing, which clearly suggests a need to improve productivity and/or shift resources to more rewarding activities.

11 Economic Council, *Looking Outward*, Chapter 12.

The foregoing attempts to put the adaptation problem into its proper perspective, particularly when adaptation requires reorganization and various degrees of contraction rather than the total disappearance of such industries. Manufacturing accounts for only 20 per cent of total employment. The sectors most vulnerable to competition from developing countries are leather goods, textiles, hosiery and knitted goods, clothing, and selected electronics products.¹² Many of the enterprises in these industries are located in or around Montreal, Hamilton, Toronto, and Winnipeg. They represent a substantial proportion of manufacturing employment—about a third in Quebec and a fifth in Ontario—but only about 7 per cent of total employment in Quebec and less than 5 per cent in Ontario.¹³ The situation appears to be particularly acute in Montreal, where a large proportion of the work force consists of married women with relatively poor education, who would likely find it difficult to readapt to either other locations or other occupations. It is rather less severe, on the other hand, in the Toronto-Hamilton-Niagara region and southwestern Ontario in general, where the proximity of many small and medium-sized towns to a large number of industrial firms facilitates movement to better jobs in more promising industries.

The situation is very critical in some of the smaller cities in Quebec and Ontario where, in general, alternative employment opportunities are less readily available. Many small towns and villages are threatened because of their greater dependence on the economic viability of one or a few firms. These communities are scattered all over the central provinces but are also numerous in other parts of the country. Their heaviest concentration, however, is in Quebec, especially in the Eastern Townships and the central and western regions of the province, as well as in the Ottawa Valley and other areas of eastern Ontario.

Given the already high levels of unemployment, especially in Quebec, it is clear that the achievement of an acceptable tariff and adjustment strategy will depend on a number of factors, including a return to a better economic performance for the Canadian economy as a whole; expanding opportunities for employment in viable industries and occupations; industrial incentive and alternative job-creation programs aimed at easing the cultural and geographic adjustment of competitively displaced

12 Admittedly, other sectors—such as furniture making—have come under increasing competition from U.S. and foreign producers. This problem has been exacerbated by the very rapid rise in Canadian labour costs relative to those in the United States. The recent depreciation of the Canadian dollar, along with greater Canadian wage restraint in the future, may hopefully increase Canada's competitiveness in this and other product lines.

13 Roy A. Matthews (assisted by Frances Mowbray), "Canadian Industry and the Developing Countries: A Preliminary Assessment of the Dependence of Employment on Manufacturing Sectors Vulnerable to Low-Wage Competition," Economic Council of Canada Conference on Industrial Adaptation, June 1977.

workers; and adequate provisions for upgrading labour skills, job retraining, and labour mobility facilities.

Conclusion

Canada is very highly endowed with both natural resources and human skills, compared with almost any other country on earth. It is in a position to improve its productivity performance within existing industries, and perhaps even more so among its new industries if better access for its exports can be negotiated with its large trading partners. The country is quite capable of creating and borrowing technology and capital in order to forge ahead.

There are, undoubtedly, short-term problems that stand in the way of a more vigorous pursuit of free trade. These include slack in the international and domestic economies, and poor international competitive performance by Canadian manufacturing enterprises overall. Nevertheless, in the longer run, it is equally clear that Canada's prosperity and economic and political interests lie in the pursuit of a policy favouring further reduction of trade barriers in a multilateral trading environment.

4 Savings, Investment, and Capital Flows

The main source of economic expansion, employment growth, and improvement in the quality of life is investment, not only in the manufacturing sector, but also in such areas as education and training, health, protection of the environment, and basic research. Investment also promotes technological advances, without which expectations of an ever-rising standard of living would falter. Traditionally, Canadian industry has counted heavily on infusions of new capital to enlarge its productive capacity and to create the potential for a greater supply of output.

New investment presupposes that a part of disposable income must be diverted from the consumption of goods and services and channeled into savings from which investors can draw or borrow. Although Canadians direct a high proportion of their private and business income into savings, Canada has traditionally needed to supplement its domestic savings with foreign borrowings in order to achieve rates of investment consistent with the desired growth of the economy and employment.

Savings

The level of gross savings¹ in the Canadian economy over the past fifteen years has ranged between 20 and 27 per cent of gross national product (GNP); it amounted to \$45.6 billion in 1976. Cyclical changes in savings rates in Canada and the United States between 1960 and 1976 were generally in the same direction, but the level and variability of savings as a percentage of GNP were substantially higher in Canada (Chart 4-1).

The flow of savings stems from four sources: the personal and unincorporated business sector; the corporate sector, including publicly

1 Gross savings include all capital consumption allowances, as well as the net savings of the personal, corporate, government, and foreign sectors of the economy. Net savings for the economy represent the change in each sector's assets over the change in its liabilities — that is, the change in its net worth.

Chart 4-1

Gross Private Savings as a Proportion of Gross National Product,
Canada and the United States, 1960-77¹



1 Data for 1977 are seasonally adjusted at annual rates. Canada: data are for first two quarters; United States: data are for first quarter.

SOURCE Based on data from Statistics Canada, and U.S. Department of Commerce, *Survey of Current Business*.

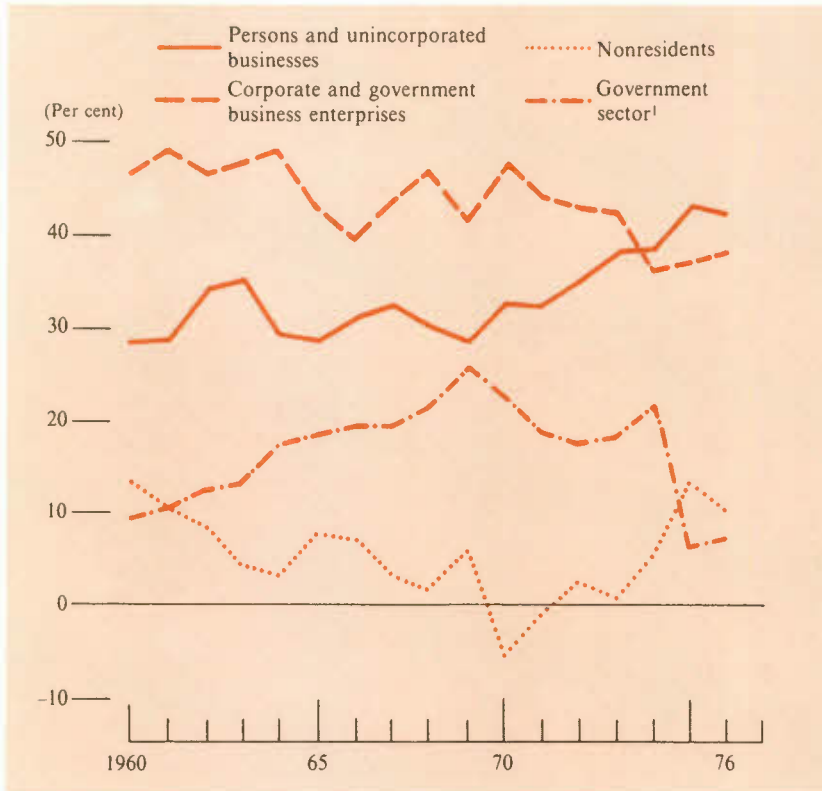
owned or operated business enterprises; the government sector; and the foreign sector — that is, foreign investors and lenders. Since 1960, there has been a rise in the importance of savings by the personal and unincorporated business sector and a concomitant decline in the relative importance of corporate savings (Chart 4-2). The corporate sector has nevertheless been the largest user of funds and has consistently relied on the savings of the other sectors, notably on personal savings, in the form of bonds, insurance and pension plans, and personal holdings of money.² With rising inflation and the consequent drain on corporate liquidity, the magnitude of these borrowings has grown.³ Inflation has also prompted individuals and

2 Including currency and bank deposits, deposits in other institutions, and foreign currency and deposits.

3 Including bonds issued by federal, provincial, and municipal governments, and by other Canadian sources.

Chart 4-2

Savings of Major Sectors as a Proportion of
Total Gross Savings, 1960-76



1 Excluding government business enterprises.

SOURCE Based on data from Statistics Canada.

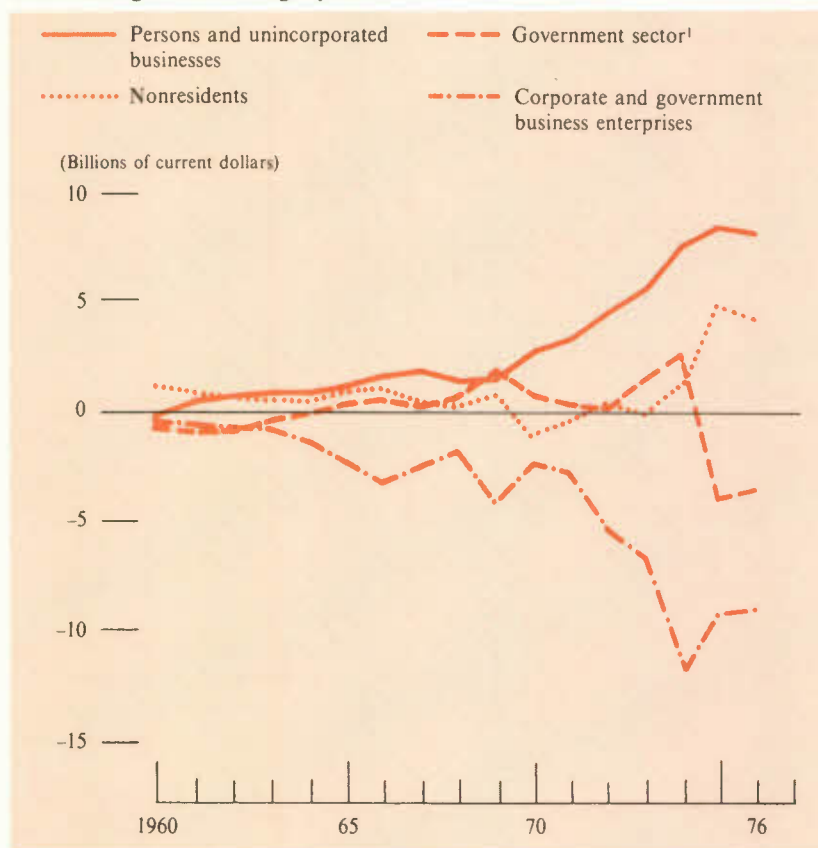
households to greatly increase their personal holdings of currency and deposits and, since 1973, to reduce their holdings of bonds.⁴ Finally, despite the high level of domestic savings, debt borrowers have come to depend more and more on nonresidents (Chart 4-3).

Since home mortgage repayments, excluding interest charges, are counted as part of after-tax personal savings and since a relatively high proportion of Canadians own their own homes, gross private savings represent a relatively high percentage of GNP. Moreover, the fast growth in

4 The impact of inflation on the income and asset/liability situation of business enterprises was examined in the Economic Council's *Thirteenth Annual Review: The Inflation Dilemma* (Ottawa: Supply and Services Canada, 1976), Chapter 4.

Chart 4-3

Net Lending or Borrowing, by Sector, 1960-76



¹ Excluding government business enterprises.

SOURCE Based on data from Statistics Canada.

real income per capita has produced a greater supply of money from which to save (Table 4-1). There is little doubt that federal incentive programs such as the registered retirement savings plans and the registered home-ownership plan have helped to boost personal savings. The proportion of personal savings as a percentage of GNP peaked in early 1976 but has been edging down since. This proportion will probably continue to decline if, as we expect, the growth rate of real income per capita slows down. Moreover, people traditionally tend to save more when they expect inflation to rise; thus, if inflation rates are brought under reasonable control, this too may prompt lower savings rates. On the other hand, private pension plans will remain an important source of savings as the numbers of new contributors grow and as more employees put larger amounts of current income aside.

Table 4-1

Gross Private Savings and Its Major Components,
as a Proportion of Gross National Product, 1961-76

	1961-65	1966-70	1971-75	1976
Gross private savings	18.1	17.7	18.6	19.8
Personal and unincorporated business net savings	3.2	3.8	5.6	7.1
Personal and unincorporated business capital consumption allowances ¹	3.9	3.6	3.2	3.2
Undistributed corporate profits ¹	3.9	3.9	4.6	3.9
Corporate and government business capital consumption allowances ¹	6.9	6.6	6.2	5.9

¹ Including miscellaneous valuation adjustment.

SOURCE Based on data from Statistics Canada.

Capital consumption allowances in both the corporate and personal sectors have declined slightly in importance, whereas there has been a rise in the proportion of GNP retained as undistributed corporate profits. As we noted in the *Thirteenth Annual Review*, rising inflation, combined with standard tax accounting practices, has had the effect of diverting a significant amount of corporate income to the public sector. In recognition of this and as a stimulus to enterprises, the federal government in its spring 1977 budget allowed firms a deduction of 3 per cent of the opening value of inventories and extended the 5 per cent investment tax credit granted in 1975 for an additional period of three years. The removal of the anti-inflation controls, along with some containment of inflation to manageable rates, should allow businesses to adjust to such relative price or wage distortions as may have occurred and permit somewhat larger real corporate net earnings and savings. Flagging international competitiveness, however, could have negative effects.

Investment

Over the past decade and a half, Canadians have devoted, on average, approximately 20 to 25 per cent of GNP to investment. Gross investment in Canada in 1976 amounted to roughly \$44 billion. A comparison with other major western industrialized countries shows Canada to be in the middle range of investment rates among the main western industrialized countries (Table 4-2).⁵ Since investment is a prime agent of economic growth, there is a general tendency for those countries with the highest rates of investment to have the highest rates of economic growth. Increases in the size and competence of the labour force are, of course, equally important.

⁵ The rate of investment is calculated as a country's gross fixed capital formation divided by its gross national product in current dollars.

Table 4-2

Investment as a Proportion of Gross National Product, and
Real Annual Growth Rate of GNP, Seven Industrial Countries, 1961-76

	1961-65			1966-70			1971-75			1976		
	Investment as a proportion of GNP	Annual increase in GNP	Investment as a proportion of GNP	Annual increase in GNP	Investment as a proportion of GNP	Annual increase in GNP	Investment as a proportion of GNP	Annual increase in GNP	Investment as a proportion of GNP	Annual increase in GNP		
	(Per cent)											
Canada	21.86	6.3	22.38	4.2	22.80	4.6	23.32	4.9				
France	22.74	5.8	25.16	5.7	23.74	5.1 ¹	n.a.	n.a.				
Italy ²	21.78	4.4	19.87	6.0	21.21	2.6	n.a.	5.6				
Japan	32.27	8.9	33.68	12.0	33.93	4.9	29.91	6.3				
United Kingdom ²	17.27	3.4	18.39	2.4	19.24	1.7	18.89	1.5				
United States	18.07	5.2	17.96	2.3	17.71	2.1	16.15	6.0				
West Germany	26.17	4.9	24.60	5.2	23.91	1.6	20.74	5.7				

n.a. — not available.

1 For the period 1971-74.

2 Based on gross domestic product.

SOURCE Based on International Monetary Fund, *International Financial Statistics*, various issues.

As a proportion of GNP, the rate of gross fixed capital formation has been substantially higher in Canada than in the United States. The level of business spending in plant and equipment in 1975 was one of the main reasons why the recession was less severe in this country. But, with idle capacity and a very large build-up of inventories, the pace of capital expansion in 1976 fell off dramatically; the expenditures on plant and equipment are currently among the weakest elements in the current phase of the recovery.

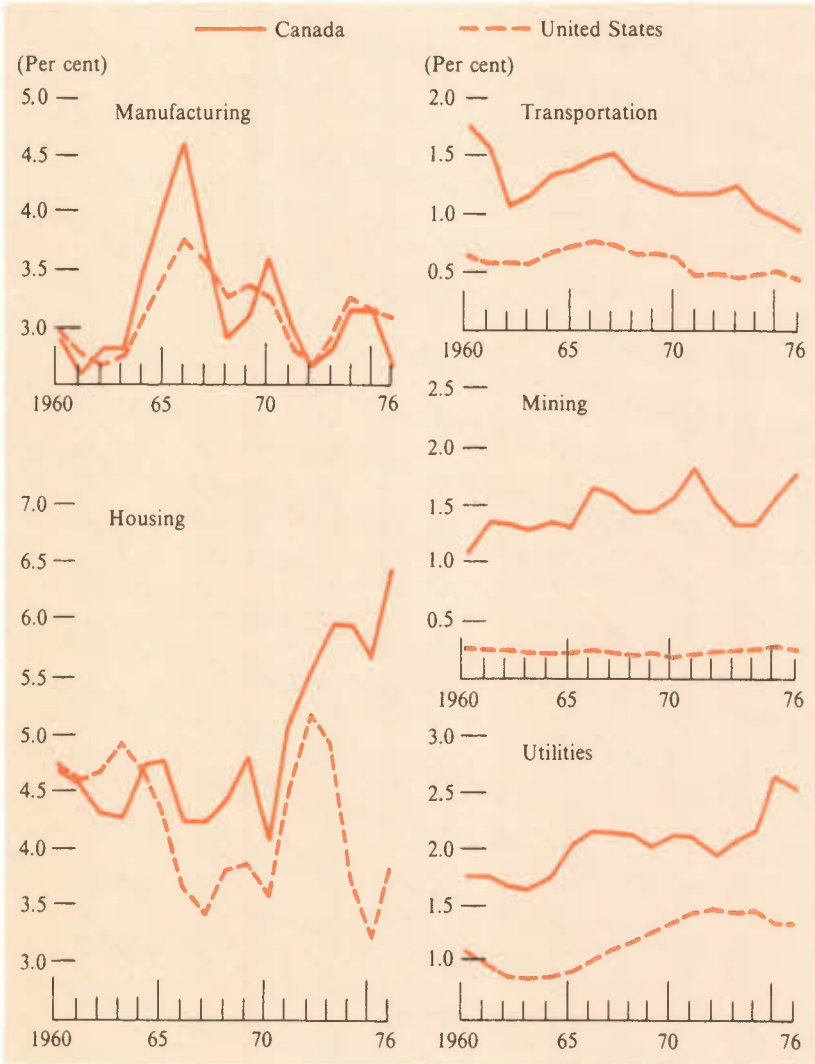
A more useful insight into the differences in industrial structure and capital needs between Canada and the United States comes from a comparison of the rates of investment, by sector. Whereas investment in the various sectors tends to follow the same cyclical patterns, the rates in all sectors except manufacturing are typically higher in Canada than in the United States (Chart 4-4).

Real growth in output depends on the contribution of both labour and capital. Because labour supply has traditionally grown faster in Canada than in the United States, Canada enjoys somewhat more favourable overall real growth rates and higher rates of return on investments, although distances between markets are greater in this country and the amounts of investment must therefore be proportionately larger. This heavier investment requirement results from a number of interrelated factors. First, partly because of the difference in population growth between the two countries, Canadians must invest proportionately more in the housing sector, where the dollar-value contribution to the productive process — and hence to GNP growth — is lower than in business plant and equipment. Second, the mere geographical size of Canada, given the low population density and the quantity of goods being moved, requires proportionately more investment in transportation and distribution facilities. Third, because many of Canada's resource industries are capital-intensive, growth can only occur through a high degree of capital reinvestment. Thus, while Canada's overall domestic rate of savings is high, it usually falls short of meeting all investment requirements. Were it not for infusions from abroad, capital would become more expensive and Canadian corporations would have to either slow their rate of expansion or use the scarcer capital more efficiently.

Within the Canadian economy, the sectoral pattern of investment has not changed too significantly from the 1960s to the 1970s. Investment in manufacturing continues to be among the most cyclically sensitive areas although, along with primary industries, transportation, and trade, its proportion of total gross fixed capital formation has tended to decline. The two sectors in which gross capital formation has gained in importance have been the finance, insurance, and real estate sector and the utilities sector — the former because of the importance of housing and the growing practice of acquiring machinery and equipment to be leased to other sectors, and

Chart 4-4

Rate of Investment as a Proportion of
Gross National Product, Selected Industrial Sectors,
Canada and the United States, 1960-76



SOURCE Based on data from Statistics Canada, and Wharton EFA Data Bank.

the latter because of the increasing relative scarcity of energy and the growing importance of long-distance communications. In the 1960s, for example, energy-related investments in such fields as petroleum, gas, and electricity production and distribution accounted for approximately 20 per cent of the output in nonresidential construction; between 1970 and 1976,

this proportion reached roughly 26 per cent.⁶ The percentage is likely to grow still higher over the next five years, with the infusion of an expected \$10 billion or more for the Arctic gas pipeline, as well as additional oil, gas, and related investment expenditures in both western and eastern Canada.

Investment, of course, is not an end in itself. Since capital is a scarce resource with its own price — that is, the interest rate — it should be used in the most productive manner possible. Some business spokesmen and organizations have on occasion seemed to want incentives to invest even though that mainly increases their costs. Prestigious buildings and overbuilt capacity are clearly not a satisfactory basis for growth and prosperity.

Capital Flows

Canada's reliance on foreign savings has to be seen in the context of the international trade situation and in conjunction with the balance of foreign indebtedness. To cover a deteriorating current account, long-term net capital inflows increased to \$3.7 billion in 1975 and \$7.9 billion in 1976 (Table 4-3). They are expected to reach about \$5 billion in 1977. This compares with an annual average of \$1.2 billion during the preceding decade.

Figures on capital flows underestimate the full historical importance of nonresident savings to the Canadian economy, since they measure only the assets and liabilities — such as currency, bonds, and stocks — that cross borders each year. They omit, however, earnings accruing to foreigners from subsidiaries and affiliates but retained for investment within Canada, as well as capital consumption allowances accruing to these foreign-owned firms. The inclusion of these sums increases the share of foreign savings to nearly one-fifth of the savings used for gross capital formation in Canada.

It is useful to make a distinction between portfolio investment and direct investment. Portfolio investment covers the purchase of public issues of bonds and debentures of corporations and governments, as well as the purchase of stock of companies listed on Canadian stock exchanges. The latter component — portfolio equity investments — involves only a limited purchase of securities so that ownership control of the enterprises concerned cannot pass into foreign hands. Foreign direct investment, as it appears in the capital account of the balance of payments, represents investments of a long-term nature by parent companies or principal owners in Canadian branches of foreign corporations or foreign-controlled companies incorporated in Canada. These transactions are related to the acquisition or sale of existing enterprises or assets, new capital formation,

6 Department of Finance, *Economic Review* (Ottawa: Supply and Services Canada, May 1977), p. 76.

Table 4-3
Capital Inflows and Outflows, Canada, 1950-76

	Net foreign lending (-) or borrowing (+)	Long-term flows					Short- term flows	
		Direct investment		Portfolio investment				
		Net	Into Canada	Abroad	Canadian securities	Foreign securities		Other
					(Millions of dollars)			
Annual average, 1950-59	-765	378	442	-64	372	2	69	1
Annual average, 1960-69	-774	430	561	-132	758	-143	67	-253
1970	1,106	590	905	-315	493	70	-177	-583
1971	431	695	925	-230	108	196	-359	-318
1972	-386	220	620	-400	1,352	244	-228	-983
1973	108	-35	750	-785	592	69	-242	-960
1974	-1,513	-50	725	-775	1,726	46	-851	666
1975	-4,779	-125	670	-795	4,494	-17	-667	690
1976	-4,187	-850	-295	-555	8,652	85	-13	-3,165

SOURCE Data from Statistics Canada.

the provision of working capital, the refinancing of existing facilities, or the withdrawal of capital.⁷

Portfolio Investment

Over the 1960-74 period, gross new issues of Canadian securities brought a total of \$20 billion in foreign portfolio capital into Canada. Allowing for retirements, this inflow amounted to \$12 billion — approximately 75 per cent of the total net long-term capital inflow during that period. All of this portfolio investment from abroad was secured through bonds and debentures, with the trade in common and preferred stocks resulting in a net outflow. By comparison, the outflow resulting from Canadian purchases of, and trade in, foreign securities amounted to \$0.8 billion.

Until 1966, corporations were the largest borrowers, followed by the provincial, municipal, and federal governments, in that order. In 1967, there was a shift in positions as provincial governments dramatically increased the value of new issues; by 1976, borrowing by all levels of government accounted for 63 per cent of the issue of new securities.

While U.S. investors continue to be the main purchasers of Canadian securities, Canadian borrowers are increasingly turning to the Euro-bond market (Table 4-4). In 1975, for example, Canadian-dollar issues in this market totalled more than \$500 million, surpassed only by issues denominated in U.S. dollars and Deutsche marks. The Middle East petroleum-exporting nations also account for an increasing share of new Canadian security purchases.

Traditionally, interest rates on Canadian bonds have exceeded those on U.S. bonds because of the proportionately greater requirements for capital in this country. This differential between long-term interest rates is crucial to the flow of funds since the wider the differential, the more attractive investment in Canada usually appears to U.S. lenders.⁸ Variations in the

7 The transactions include the net acquisition of share capital and changes in loan capital, in branch/parent company indebtedness, and in intercompany accounts resulting from transfers of cash, merchandise, or services. Flows of "foreign investment" are just one source of funds available to foreign-owned subsidiaries and affiliates. Funds can be generated internally by the subsidiary in the form of retained earnings, capital consumption allowances, and depletion allowances, or externally through debt or equity borrowing in the Canadian market or in a foreign market (country of control or otherwise). None of these sources are included in "foreign direct investment" in the capital account. Borrowing in a foreign market would be considered "portfolio investment" in the capital account.

8 Several other important factors explain capital flows — for example, differences in the rating of industrial bonds, government taxation of bonds, and the Canadian withholding tax on interest payments abroad. Exchange rate expectations are an additional factor. In addition to affecting the total sale of bonds, such expectations will likely shape the proportion of issues that are denominated in Canadian dollars as distinct from the currency of the lender. Lenders holding "foreign-pay" bonds are not directly affected by an appreciation or depreciation of the borrower's currency; those holding "domestic-pay" bonds are. Tentative estimates suggest that about 80 per cent of Canada's outstanding debts are of the "foreign-pay" type.

Table 4-4

New Canadian Security Issues, by Source and by Destination, 1952-75

	1952-59	1960-69	1970-75
	(Per cent)		
Source			
Corporations	47	46	30
Government			
Federal	4	8	2
Provincial	30	34	61
Municipal	19	12	7
Total	100	100	100
Destination			
United States	90	89	72
United Kingdom	5	3	4
Other	5	8	24
Total	100	100	100

SOURCE Data from Statistics Canada.

differential have been mirrored in changes in the total value of gross new issues. Canada's monetary strategy in 1974-76 resulted in a higher level of interest rates here than in the United States and, on average, the differential in long-term interest rates reached 1.5 and 1.7 percentage points in 1975 and 1976, respectively. The consequence was a heavy inflow of foreign portfolio investment — a reversal of the usual situation during an economic downswing, wherein the amount of new issues sold abroad declines.

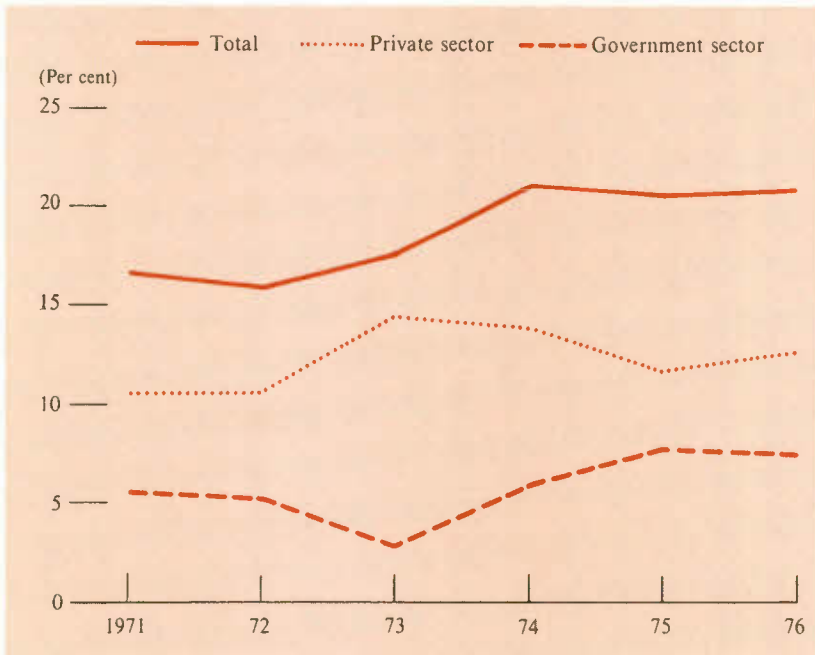
The general demand for funds was strong throughout the three-year period. Borrowing as a proportion of gross national expenditure (GNE) rose sharply from 16.6 per cent in 1971-73 to 20.7 per cent in 1974-76 (Chart 4-5). During the downturn in the latter part of 1974 and in 1975, private portfolio investment grew only moderately. Businesses outside the financial sector reduced their cash liquidity by several billion dollars, and some turned from bank loans and other short-term sources to the long-term bond market in an effort to lengthen the term structure of their debt. But the major increase in foreign borrowing in 1975 originated from provincial and municipal governments and from provincial utilities. In contrast to the private sector, provincial enterprises continued to increase their fixed investment outlays throughout the downturn.

In 1976, provincial and municipal governments continued to rely heavily on bond sales, but corporate borrowing abroad also expanded. Foreign lenders were encouraged by the removal of the 15 per cent withholding tax on the interest and dividends accruing to nonresidents, which had previously applied to all securities other than government bonds. Whereas

the value of the securities sold to nonresidents by governments and nonfinancial corporate institutions totalled about \$0.5 billion in 1973, it was roughly \$8 billion in 1976.

Chart 4-5

Funds Raised by Major Nonfinancial Borrowers as a Proportion of Gross National Expenditure, Canada, 1971-76



SOURCE Based on data from Statistics Canada.

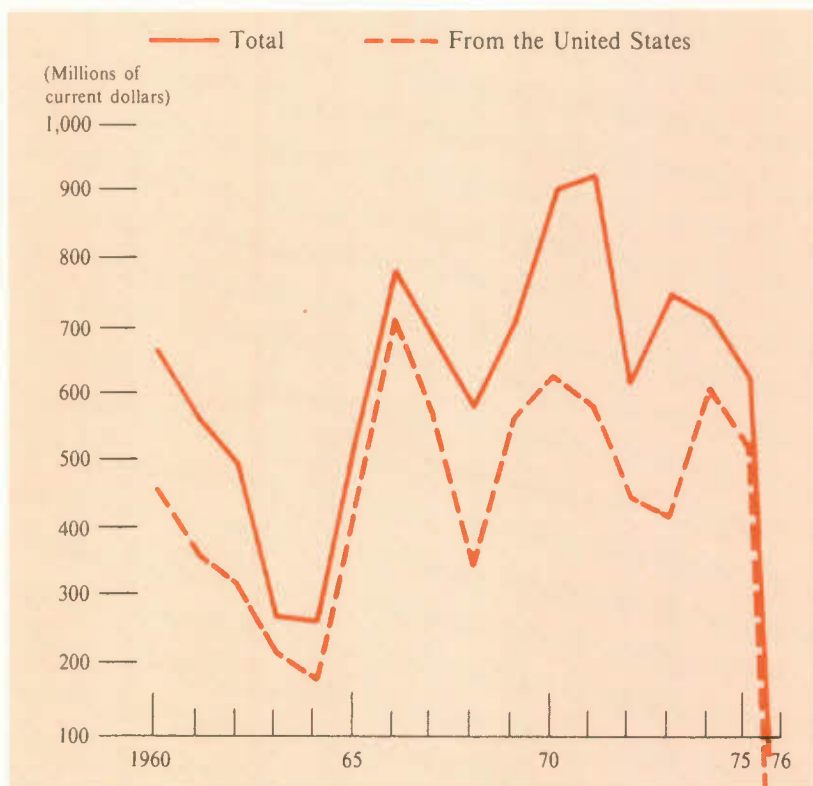
Foreign Direct Investment

Over the 1960-74 period, direct investment flows into Canada totalled \$9.5 billion, slightly less than the \$11.8 billion cumulative inflow from trade in Canadian securities. Retained earnings ploughed back into foreign-owned enterprises contributed an additional \$16.3 billion. By 1976, the book value of foreign direct investment amounted to nearly \$44 billion.

As with portfolio investment, U.S. investors account for the greatest share of annual inflows of direct investment into Canada (Chart 4-6). During the 1950s and 1960s, the United States provided 75 per cent of the total, followed by the United Kingdom with 13 per cent. If direct investment drawn from retained earnings is included, the share contributed

Chart 4-6

Direct Foreign Investment Flows into Canada, 1960-76



SOURCE Based on data from Statistics Canada.

by the United States is even greater — 80 per cent. Direct inflows from the European Economic Community and from other countries accelerated in the 1970s, and the shares of the United States and the United Kingdom declined to 70 and 6 per cent, respectively. The petroleum, natural gas, and mining industries have been the main beneficiaries of new capital inflows from the United States (Table 4-5).⁹

Although foreign direct investment into Canada has more or less followed the path of real GNP growth, there has been a downward trend since 1971; in 1976 there was a large net outflow. This dramatic decline in

9 Nonresident funds represent a substantial part of the total capital invested in these sectors. If total investment is reclassified according to whether the voting stock of the firms is or is not controlled by nonresidents, it appears that the petroleum and natural gas industry is 76 per cent foreign-controlled; mining and smelting, 57 per cent; and total manufacturing, 59 per cent.

Table 4-5

Distribution of Change in U.S. Direct Investment in Canada,
by Industry, 1952-73

	Direct investment	
	Inflows	Inflows plus retained earnings
	(Per cent)	
Petroleum and natural gas	36	31
Mining	24	11
Manufacturing		
Pulp and paper	5	7
Iron and iron products	—	16
Nonferrous metals	22	4
Chemicals	—	6
Other	—	7
Utilities	1	—
Merchandising	5	6
Finance	4	9
Other industries	3	3
Total	100	100

— negligible.

SOURCE Based on data from Statistics Canada.

net investment has been caused primarily by a substantial repatriation of U.S.-owned assets to Canada.¹⁰

Nonetheless, allowing for these capital movements as well as new issues, retirements, and borrowing abroad by U.S.-controlled enterprises, the book value of U.S. investment in Canada has continued to rise, mainly as a result of increases in internally generated funds (Table 4-6). About 80 per cent of the increase in U.S. claims on the Canadian economy during the 1970s has originated from retained corporate earnings. A similar situation occurs in many other countries borrowing abroad, but the ratio there remains well below that in Canada. In short, data on the book value of total foreign direct investment show that there has been no decline of foreign ownership in Canada.

Canadian Investment Abroad

In general, Canadian direct investments abroad represent an extension of the corresponding activities of Canadian-owned firms or of develop-

10 In 1973, for example, the Canada Development Corporation (CDC) tendered for 30 per cent of Texas Gulf Sulphur Inc., effectively transferring control of the U.S. company to the Canadian government. In 1976, the CDC acquired most of the oil and gas interests of Tenneco Inc. of Houston. In the same year, the Canadian government took over Canadair Ltd. from General Dynamics. Repatriation was not limited to U.S.-owned companies; for example, De Havilland Aircraft of Canada Limited was taken over from its British parent company in 1974. Outflows also cover capital repayments arising from funds generated within enterprises in Canada.

ments ancillary to their Canadian operations. Examples are investments in beverages, agricultural implements, mining and smelting, pulp and paper, petroleum, and natural gas. Other Canadian direct investments abroad are designed to integrate the raw material sources with Canadian processing enterprises or involve an extension of transportation facilities, such as the Canadian-owned railway facilities in the United States and the sections of Canadian pipelines located in that country. Naturally enough, the United States has attracted the greatest Canadian interest (\$5 billion), followed by Brazil (\$1 billion) and the United Kingdom (\$0.9 billion).

Table 4-6

Net Increase in Book Value of
Foreign Direct Investment in Canada, 1965-76

Average 1965-69	1970	1971	1972	1973	1974	1975	1976
(Billions of dollars)							
1.7	2.0	1.5	1.6	3.4	3.4 ¹	3.7 ¹	3.8 ¹

¹ Estimates.

SOURCE Data from Statistics Canada.

Many Canadian enterprises with ownership in assets abroad are multinational organizations that embody a substantial proportion of nonresident ownership. Canadian subsidiaries of foreign corporations are included in the Canadian figures. A few very large corporations play a prominent role in these direct investments abroad. At the end of 1973, almost 75 per cent of Canada's total investment abroad came from 25 enterprises with investments in excess of \$50 million. Of these enterprises — 2.8 per cent of all Canadian firms investing abroad — 17 were Canadian-controlled.

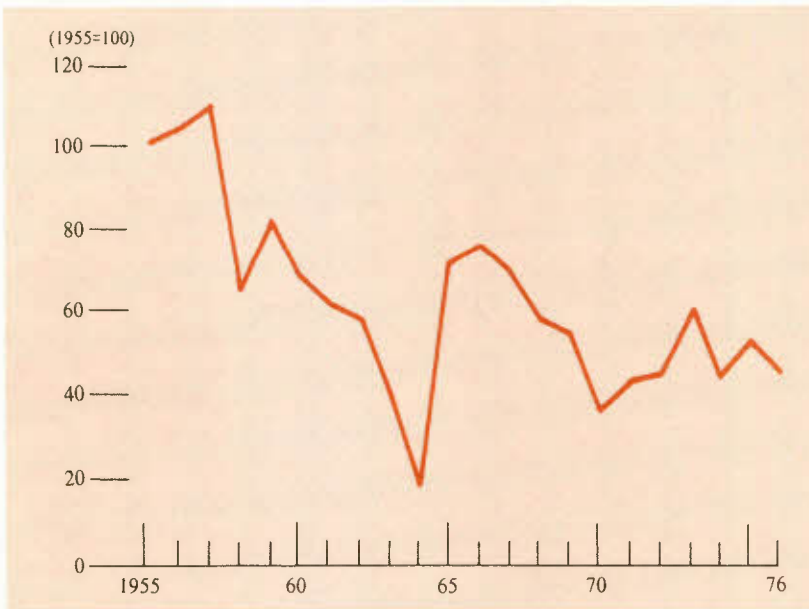
Annual outflows of direct investment have accelerated in the 1970s, exceeding \$500 million every year since 1973. In combination with the decelerating annual inflows of direct investment capital, the result has been a negative net balance on Canada's annual flows of direct investment. When the net change in direct investment flows relative to 1955 is examined in index form,¹¹ the downward trend in the annual increases of foreign investment in Canada relative to Canadian direct investment abroad is

11 The derivation of the index follows a technique developed by the Conference Board in Canada, except that it covers retained earnings, revaluations, and other factors that serve to increase direct investment in addition to capital flows. See Charles A. Barrett, "What is Happening to Foreign Investment in Canada? Economic Trends and Public Expectations," *The Canadian Business Review* 3, no. 3 (Summer 1976), pp. 41-44.

confirmed (Chart 4-7).¹² The downward trend would have been even more pronounced had not other factors offset much of the net outflow of direct

Chart 4-7

Index of Net Change in
Book Value of Direct Foreign Investment
as a Proportion of Gross National Product, 1955-76¹



1 The index was obtained by using the following formula:

$$\frac{\left[\frac{(\text{Inflow} + \text{other factors}) - (\text{Outflow} + \text{other factors})}{\text{GNP}} \right]_t}{\left[\frac{(\text{Inflow} + \text{other factors}) - (\text{Outflow} + \text{other factors})}{\text{GNP}} \right]_{1955}}$$

SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada.

- 12 Developments in the individual series on outflows and inflows have been sharply affected by large nonrecurring transactions and "other factors," which include retained earnings, new issues and retirements, and accounting adjustments and reclassifications. "Other factors" contributing to direct investment abroad have fluctuated within a fairly narrow range — between \$72 million and \$362 million. The years 1970, 1972, and 1974 were exceptions. In 1970, Brascan Limited was reclassified. It had originally been considered a foreign business corporation with sizable investments abroad. The equity of Canadian residents in this enterprise was shown as portfolio investment abroad. With the establishment of diversified investments in Canada and the relinquishment of the company's tax status as a foreign business corporation in 1970, the equity holdings became part of direct investment with no actual capital flow and hence a part of "other factors." In 1972, IU International Corporation (formerly International Utilities Corporation) ceased to be a Canadian corporation, and Canadian participation in the enterprise was transferred to portfolio investment abroad. Take-overs of foreign firms by Canadian-based enterprises affected the statistics on "other factors" in 1974. Canadian publications do not separate retained earnings from "other factors."

investment in recent years. Whether this net outflow is cause for alarm or a sign of growing maturity in capital borrowings by Canadians is a highly significant issue.

Foreign Borrowing and International Indebtedness

Despite the growing deficit in the balance on current account, the purchase of Canadian securities has been strong enough to counterbalance a lagging demand abroad for Canadian goods and services. Long-term borrowing was in fact so great in the first half of 1976 that there was a short-term capital outflow, and the value of the Canadian dollar was above parity with the U.S. dollar. With the subsequent depreciation of the Canadian dollar, the short-term capital outflow has eased and the pace of long-term borrowing has leveled off below the 1976 figure.

The acceleration in Canadian borrowing in the 1970s has also had important implications for Canada's balance of international indebtedness (Table 4-7). Since debt-service payments fall due regardless of the state of the economy, the shift from equity financing to debt financing has itself created problems. Interest payments alone equal more than the total earnings from Canadian wheat exports.

In general, Canada benefits from borrowing for productive investment to expand capacity or for stabilization purposes, since the stream of subsequent benefits almost inevitably outweighs the costs. But, to the extent that debts are incurred at a time of extraordinarily high interest charges or for purposes that do not enhance Canada's economic potential, future interest payments could place a heavy burden on the economy.

Table 4-7

Balance of International Indebtedness,¹ Canada, Selected Years, 1950-76

	Net indebtedness			
	Long-term			Short-term
	Total	Direct investment	Other, including portfolio investment	
	(Billions of dollars)			
1950	4.5	3.0	2.3	- 0.8
1960	16.6	10.4	7.6	- 1.4
1970	28.5	20.2	15.0	- 6.7
1975	43.3	29.9	21.1	- 7.7
1976	48.5	32.5	28.0	-12.0

¹ Changes in net indebtedness reflect net international investment, which appears in the capital account; net reinvestment abroad of foreign-earned profits; and net changes in the value of overseas assets.

Positive values indicate the amount owing to foreigners by Canadians; negative values, the converse.

SOURCE Based on data from Statistics Canada.

Conclusion

Looking ahead, Canada's decelerating labour force growth will be accompanied by some reduction in new house building. But the rate of growth of new entrants to the labour force will still be greater than in the United States. If Canada is to generate the growth required for continued real income gains per worker, investors will have to match the growth in the labour supply with appropriate infusions of new capital. Whole new industries are on the threshold of development, such as those that will emerge through the application of silicon chips in electronics, the use of lasers in the metallurgical and health fields, and the spreading use of satellites in telecommunications. Moreover, many Canadian firms and some entire industries will need to modernize their plant and equipment drastically if they are to continue to compete with import substitutes and in export markets. In addition, developments in the energy and energy-conserving field, together with a sustained world demand for raw materials, augur continued high levels of investment over the medium and longer term.

However, the persistence of unused capacity, slow consumer spending, and relatively high capital costs in relation to static profit rates is at present working against renewed business spending and investment expansion in Canada. Over the long term, however, there seems little doubt that Canadians must continue to save at considerably higher rates than their American neighbours simply to sustain the higher rates of new capital formation that this country's industrial structure requires. Indeed, our industrial restructuring requirements are such that, in the absence of direct government intervention to encourage an even higher level of domestic savings than exists now, the prospect is for continued heavy dependence on foreign lenders to supplement Canadian savings well into the 1980s.

5 Policy Options for the Years 1977 to 1982

In 1975, we analysed several growth options associated with future developments on the international scene and in the area of energy prices.¹ It now seems clear that the "high-price" energy scenario discussed at that time comes closest to current patterns. Consequently, this chapter extends the findings of the *Twelfth Annual Review* and, in the present context, explores alternative policy options designed to achieve Canada's economic objectives more efficiently.

Since its *Ninth Review*, the Council has used a target unemployment rate of 4.5 per cent to represent a high degree of capacity utilization in the Canadian economy. However, recent research, including the Council's own study of the labour market,² has emphasized how demographic and institutional factors have increased the size of the "threshold" labour force — that is, the number of persons not committed to continuous full-time employment. This development makes it more difficult to achieve a stipulated target of reduced unemployment, since the increased availability of jobs resulting from a higher level of economic activity tends to induce the members of this "threshold" group to enter the labour force. Nonetheless, it is clear that reducing unemployment rates to the lowest possible level must remain one of the prime targets of policymakers.

Containing inflation, of course, represents another major objective of economic policy, not only because inflation may exert adverse effects on various agents in the economy,³ but also because it is vital for the Canadian economy to retain its international competitiveness. In this respect, the continued deficit in the current account of the balance of payments remains a source of deep concern and should not be overlooked in an examination of Canada's medium-term economic performance.

1 Economic Council of Canada, *Twelfth Annual Review: Options for Growth* (Ottawa: Information Canada, 1975).

2 Economic Council of Canada, *People and Jobs: A Study of the Canadian Labour Market* (Ottawa: Information Canada, 1976).

3 Economic Council of Canada, *Thirteenth Annual Review: The Inflation Dilemma* (Ottawa: Supply and Services Canada, 1976).

In this *Review*, we extend the analysis to these other areas in order to show the extent to which trade-offs occur between the achievements of different objectives. For example, the relative cost of reaching a lower unemployment rate could be a higher inflation rate. Conversely, policy changes aimed at lowering the rate of growth of prices or the deficit in the current account of the balance of payments could bring about measurable increases in the unemployment rate.⁴

In our examination of alternative medium-term policies for Canada, we used the CANDIDE econometric model to develop macroeconomic simulations, constructed in three steps. First, given the considerable degree to which international conditions shape Canada's economic performance, various assumptions were made about the external environment. Second, a simulated projection of the economy, or "reference solution," was developed on the general assumption that no radical changes would occur in the market structure or in the way governments normally respond to cyclical changes in economic activity. This approach permitted examination of the overall consequences of projected developments for Canada on the assumption that the economic agents will act much as they have in the past, as well as identification of those developments that could pose difficulties for the future. Third, several simulations were made on the basis of alternative economic policies aimed at bringing the economy closer to levels of performance compatible with the objectives and preferences of Canadians.

Some Initial Assumptions

A major factor affecting Canada's economic well-being is the state of activity elsewhere. Accordingly, we have made assumptions about future developments abroad. First, the U.S. economy is not expected to maintain the strength of the 1976 recovery much beyond the end of 1977. From 1978 on, the growth rate of the gross national product (GNP) in constant dollars is projected to decelerate steadily to about 3.5 per cent in the early 1980s (Table 5-1). In addition, output in the other major western industrialized countries is expected to grow at an average of 6 per cent annually between 1978 and 1982. In all cases, inflationary pressures remain a fundamental concern, and they caution against stimulating demand excessively through strongly expansionary policies. This is evidenced by the trend in the U.S. GNP deflator, which is not expected to drop below the levels observed immediately before the energy crisis of 1973-74.

4 The main lines of this approach are similar to those described in Judith Maxwell, *Policy Review and Outlook, 1977: An Agenda for Change* (Montreal: C. D. Howe Research Institute, 1977), pp. 18-19.

Table 5-1

Assumptions about the External Environment,
CANDIDE Model 1.2M, 1978-82

	Annual rate of growth				
	1978	1979	1980	1981	1982
	(Per cent)				
U.S. real gross national product	4.3	4.0	3.8	3.5	3.4
	(Percentage of labour force)				
U.S. unemployment rate	6.5	6.1	5.8	5.1	5.3
	(Per cent)				
Overseas industrial production	6.3	5.6	5.7	6.0	6.2
U.S. GNP deflator	6.1	6.1	6.4	5.8	5.6
Import price of fuels	8.1	7.0	7.0	7.0	6.9

SOURCE Estimates by the Economic Council of Canada, based on data from the Wharton EFA model.

On the domestic scene, Canada's long-term market growth is largely related to demographic factors. Population growth is expected to decelerate in the years ahead as a result of earlier decreases in fertility rates (Table 5-2). In addition, we assume that the level of net immigration will remain at 100,000 persons annually. Labour force participation is expected

Table 5-2

Assumptions about the Domestic Environment,
CANDIDE Model 1.2M, 1978-82

	1978	1979	1980	1981	1982
	(Per cent)				
Population (annual change)	1.0	1.4	1.1	1.1	1.1
Total participation rate ¹	59.1	59.4	59.6	60.0	60.1
	(Thousands)				
Net immigration	100	100	100	100	100
	(Per cent)				
Tax rate on first taxable income bracket	6	6	6	6	6
Tax rate on second taxable income bracket	18	18	18	18	18
High-powered money supply ² (annual change)	9.4	10.7	11.0	10.5	10.2
	(\$ U.S.)				
Exchange rate of Canadian dollar	0.93	0.93	0.93	0.93	0.93

1 Labour force as a proportion of working-age population, based on figures from nonrevised Labour Force Survey.

2 Defined as chartered bank reserves plus Bank of Canada notes held outside chartered banks.

SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada.

to continue to increase over the medium term, partially counterbalancing the eventual deceleration of the labour force growth rate that will result from the declining rate of population increase. These developments have clear implications for the unemployment rate in the medium term. If foreign and domestic markets do not provide strong growth in employment opportunities, unemployment is bound to remain high.

A second set of assumptions about the domestic environment concerns policy-related variables. In general, the measures announced in the March 1977 federal budget and, more recently, in the October *Economic and Fiscal Statement* of the Minister of Finance are represented in the reference solution.⁵ In the case of government expenditure, the October decisions remain in line with the restrictive policy initiated in December 1975. On the revenue side, the fiscal incentives to investment and consumption that were introduced will provide a modest stimulus to the economy. In the reference solution, personal income tax rates are kept unchanged for the entire projection period, and the indexation provisions are maintained. Restraints on public spending are expected to continue over the medium-term period under study. Controls on wages and prices are phased out gradually.

In the simulations that focus on fiscal initiatives and in the reference solution, we postulated that the Bank of Canada would allow the money supply to expand at approximately the same average rate of growth as nominal GNP. The money-supply variable directly subject to policy changes in the CANDIDE model is the monetary base, also called high-powered money.⁶ Over the 1976-82 period, high-powered money is expected to expand at an average rate of about 10 per cent.

Finally, the Canadian dollar is assumed to continue to float at an average level consistent with monetary policy and with the current account deficit implied by the growth patterns of real expenditures. Since the current account deficit is projected to remain high, the exchange rate is unlikely to return to parity. In the reference solution, we assume that the value of the Canadian dollar will hover around \$U.S. 0.93.

The Reference Solution

What growth characteristics result from these policy and nonpolicy assumptions? Real GNE is projected to increase at an average annual rate of 4.3 per cent for the period. After a modest recovery sustained mainly by exports in 1978 and 1979, the reference scenario suggests that growth in

5 It might be noted that the difference between the estimated revenues and expenditures for 1976-77 presented in March and the actual amounts reported by the Minister of Finance in his *Economic and Fiscal Statement* of October 20 are \$400 million and -\$200 million, respectively. For 1977-78, the differences between the March and October estimates are -\$1,000 million and \$650 million, respectively.

6 See Chapter 2, p. 23, footnote 8.

GNP will decelerate steadily to a rate of about 4 per cent in 1982. This slowdown will result partly from a more modest growth of external markets. Domestically, capital spending will be sustained by the energy-related construction projects initiated in this period; however, this stimulus will likely be localized, and the multiplier effects of these projects will probably not be strong enough to offset the effects of a less vigorous external environment. Hence, given the modest growth pattern in real expenditures, employment is not expected to grow much faster than the labour force, and the unemployment rate is likely to remain above 8 per cent throughout the entire medium-term period.

Can we expect a significant deceleration in the rate of inflation as a result of relatively weak trends in both final demand and the labour market? Probably not. In fact, the rate of growth of the consumer price index (CPI) is not anticipated to drop below 6 per cent until 1982. Prices could retain this upward momentum for two reasons. Since the inflation rate in other industrialized countries is projected to remain high over the next few years, domestic prices are also likely to be submitted to further upward pressures. And, although wage and price controls may have curbed inflationary expectations to a certain extent, cost-push pressures will likely remain.

The influence of a weakening external environment, of persistent inflation, and of high unemployment is not likely to provide much relief from the economic discomfort that Canada has experienced in recent years. Foreign indebtedness will continue to increase, and the current account of the balance of payments is expected to register an average deficit of slightly over 2.0 per cent of GNP during the 1977-82 period. This represents recurring average annual deficits in the order of \$6 billion in current dollars.

Alternative Scenarios

The reference scenario suggests that, without major new policy initiatives, the outlook does not appear to be too promising. What, then, are the options that could promote a better balance of objectives and bring about less inflation combined with the more vigorous growth needed to reduce the unemployment rate? In simulating policy options aimed at strengthening the economy, we have considered two monetary options, three fiscal ones, and a combination of them, all of which may be compared with the reference solution (Table 5-3).

A Tighter Monetary Policy

The rate of monetary expansion assumed in the reference solution may be reduced, in order to achieve lower rates of inflation through the

implementation of a tighter monetary policy. Such a policy option was simulated by constraining the growth of high-powered money to an average rate of 8.3 per cent annually over the 1977-82 period. In this situation, short-term and long-term interest rates would rise, and larger inflows of foreign capital would be generated, resulting in upward pressures on the exchange rate. As a consequence, the value of the Canadian dollar would likely appreciate to an average of \$U.S. 0.96.

The effects of these measures would be transmitted to the different components of the system through two channels. When the exchange rate appreciates, the prices of imports and consequently final demand goods tend to increase less rapidly than otherwise. Second, higher interest rates tend to slow down the growth of domestic capital spending and thus alleviate upward pressures on prices from the real-demand side.

In comparison with the reference solution, the restrictive effects of a tighter monetary policy would slow down overall real growth to 4.1 per cent in the period (Chart 5-1). Slower growth and reduced domestic activity would result in a lower level of imports and an improvement in the current account of the balance of payments. The CPI also shows a more satisfactory performance in this scenario, as its yearly growth rate remains below that projected in the reference solution. Such a policy stance, however, leads to a deterioration in the job market, where the unemployment rate is substantially above that projected in the reference scenario.

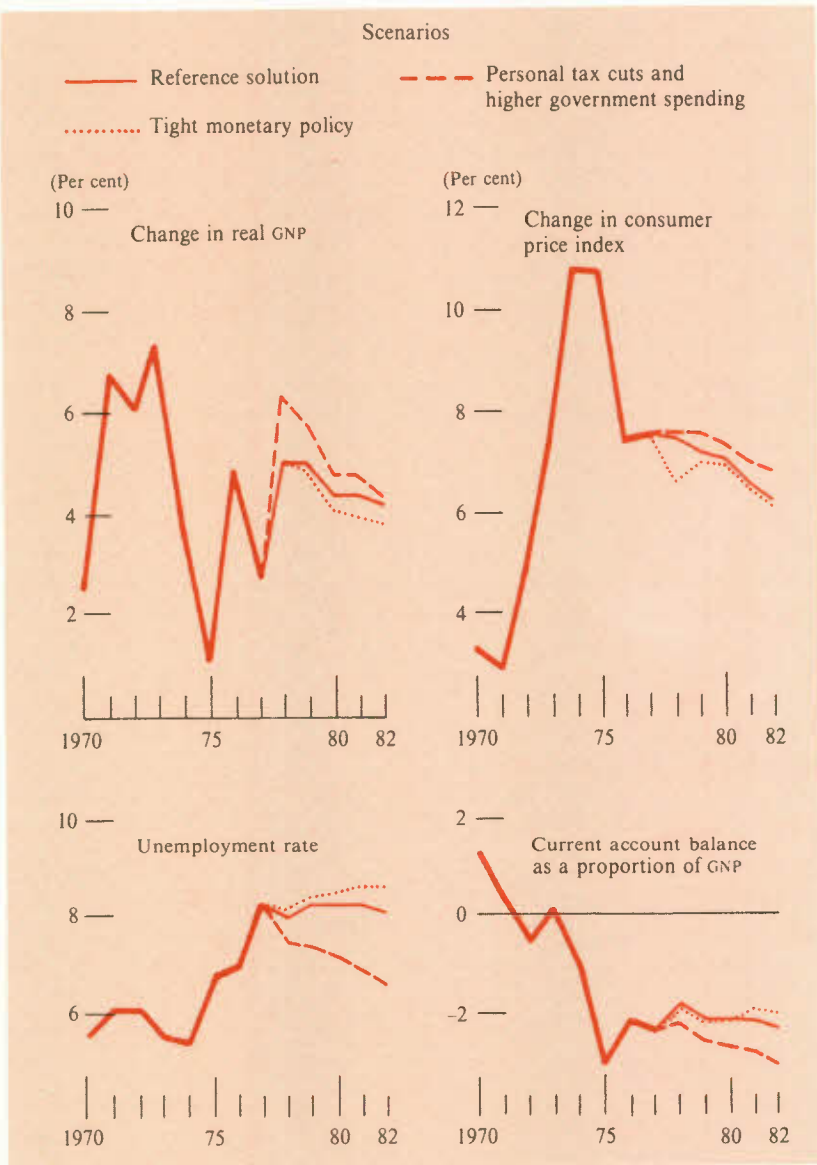
Personal Income Tax Cuts and Higher Government Spending

At the other extreme, we considered a strategy designed to stimulate aggregate demand vigorously and to reduce unemployment substantially through tax cuts and increased government spending. To this end, we assumed that, beginning in 1978, personal tax rates would be reduced by 25 per cent in the lowest taxable income bracket and by some 8 per cent in all other brackets. This would represent cuts totalling about \$2 billion. On the spending side, the downward shift in government expenditures resulting from the 1976-77 restraint was assumed to continue in 1978; however, expenditures were assumed to resume their previous levels in 1979 and to move along that path in subsequent years.

The adoption of these stimulative measures would generate a strong progression in aggregate demand and a pronounced reduction in the unemployment rate to a level of about 6.5 per cent by 1982. This improvement in economic growth and employment, however, would be obtained at the cost of higher inflation rates and current account deficits. The deterioration in the balance of payments would lead to further depreciation of the Canadian dollar, and price increases would average

Chart 5-1

Change in Selected Indicators in Three Medium-Term Scenarios, CANDIDE Model 1.2M, 1970-82



SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada.

7.3 per cent over the period, compared with some 7 per cent in the reference solution.

With all this domestic stimulus, why does it take five years for the unemployment rate to drop below 7 per cent? One reason is that the participation rate of the "threshold" work force increases when economic activity picks up. Another is the modest growth expected in foreign markets, which would limit employment growth in the export-oriented sector and also contribute to the severity of Canada's balance-of-payment difficulties.

Personal Income Tax Cuts Only

An alternative fiscal policy was simulated, in which only the personal income tax cuts were retained, leaving the achievement of a reinvigorated economy through increased spending mainly in the hands of the private sector. The tax reductions would increase personal nominal disposable income, and the usual multiplier effects would take place. Consumption and investment expenditures would increase so that real growth would be higher, and unemployment lower, than in the reference scenario. Increased private spending would lead to a rise in imports and a deterioration of the current account balance. Reduced unemployment would be obtained at the cost of further inflation — a reflection of upward wage pressures on price levels and the higher import costs associated with a depreciated dollar.

Personal Income Tax Cuts and Sales Tax Reductions

We simulated the effects of another fiscal policy combining personal income tax cuts and retail sales tax reductions. In this scenario, we postulated, in addition to the personal tax cuts of the preceding scenario, a sales tax reduction of 1 percentage point for items bearing a tax rate of 5 per cent or more.⁷ As noted by the C. D. Howe Research Institute,⁸ reductions in provincial sales taxes would increase the purchasing power of consumers, reduce the rate of increase in the CPI, and favour low-income families, who are more heavily burdened by sales taxes.

The main characteristic of this scenario is that, compared with the two previous fiscal-policy scenarios, it shows slower consumer price increases as a result of the sales tax reduction. In terms of aggregate growth and unemployment, it is situated halfway between the scenario postulating personal income tax cuts only and that based on personal income tax cuts plus increased government spending.

7 Sales taxes on tobacco, alcohol, and gasoline were kept unchanged.

8 Maxwell, *Policy Review and Outlook*, pp. 106-7.

This scenario also leads to a larger current account deficit. Even though imports would not increase as fast as in the scenario based on higher government spending, the growth rate of total imports would remain high, essentially because of the effect of increased consumer spending on foreign trade. While this solution provides a relatively high growth of GNE, accompanied by a slightly lower inflation rate than in the two preceding fiscal policy solutions, it still implies persistent heavy reliance on long-term capital inflows from abroad to offset major balance-of-payments deficits.

Personal Income Tax Cuts and Tighter Monetary Policy

In comparison with the reference solution, the three fiscal policy scenarios described so far lead to lower unemployment rates accompanied by higher inflation rates, resulting not only from pressures on productive capacity but also from higher import prices associated with the depreciating Canadian currency. By contrast, the tight-monetary-policy scenario presented earlier showed that inflation could be curbed in the medium term but at severe cost in terms of unemployment. In this context, it may be useful to examine the impact of a policy mix that would be expansionary on the fiscal side and restrictive on the monetary side, and to determine whether the positive effects of each measure would still occur if the two were used concurrently.

In this scenario, we retained the assumption about personal income tax cuts but postulated that the expansion of high-powered money would be constrained to an average annual growth of about 9 per cent over the medium term. We took account of two opposing forces regarding the exchange rate: while the import stimulus created by the tax cuts would bring about downward pressures on the Canadian dollar, a restrictive monetary policy would result in higher interest-rate differentials and favour capital inflows and a higher exchange rate. Accordingly, the Canadian dollar is postulated to average \$U.S. 0.95 over the period, which is higher than the value associated with an expansionary fiscal policy but lower than that resulting from a restrictive monetary policy.

As expected, the results of this simulation in terms of aggregate growth lie between the rates displayed by the three scenarios based on a stimulative fiscal policy and those associated with the scenario based on a tight monetary policy. With regard to inflation, however, the results would be closer to those provided under a restrictive monetary policy.

An examination of some other important indicators shows that the outcome of this policy option might not be without problems. Current account deficits would remain high, and the unemployment rate would average 8 per cent over the period. Moreover, this policy mix would exert

mutually reinforcing upward pressures on interest rates and lead to adverse effects on business capital spending and housing construction.

Expansionary Monetary Policy

The expansionist scenarios presented so far were all based on some form of fiscal incentives — namely, tax cuts, increased government spending, or a combination of the two. What, then, would happen if, instead of relying on fiscal policy, monetary policy alone were used to stimulate the economy? To simulate such a policy stance, we assumed that high-powered money would be allowed to expand at an average rate of 13 per cent.

The lower interest rates associated with a more rapid expansion of the money supply would strongly stimulate private investment and generate higher GNE growth and somewhat lower unemployment than in the reference solution. But these relative gains would tend to be offset by stronger inflationary pressures and further depreciation of the Canadian dollar because of the narrowing Canada/U.S. interest-rate differential. In contrast, the three fiscal-policy scenarios involving no specific intervention on the monetary side tend to generate more employment, less inflation, and at least as much growth as the present solution.

Conclusion

In appraising these alternative policy scenarios, it appears that — if our extrapolations and assumptions are correct — there is little hope of achieving simultaneously a low unemployment rate, a low inflation rate, and sound equilibrium of the current account balance over the next five years. It is possible, however, to gauge the trade-offs and to measure the relative gains and losses of different policies with respect to growth, unemployment, inflation, and the balance of payments.

Our simulations indicate that the recourse to stimulative policies may improve the medium-term performance of the economy in some areas but that, in other fields, additional initiatives will be required. This in turn suggests that structural problems cannot be solved by the sole use of stabilization instruments, although a healthier economic environment may facilitate the achievement of needed structural adjustments.

6 Conclusions and Recommendations

As Canada moves towards the 1980s, difficult choices lie ahead. The present unsatisfactory performance of the economy reflects, in our view, a number of deep-rooted structural weaknesses. While these were less evident during the business upsurge of the early 1970s, they became obvious during the cyclical decline of 1974-75, and they are inhibiting the recovery today. In the longer term, they will require attention and decisions by all sectors of society.

Because these structural weaknesses impose constraints on traditional stabilization tools, as shown in Chapter 5, the choice of a medium-term policy strategy involves a series of dilemmas. Poor economic performance calls for conventional, contracyclical stimulative action. Such action could add to inflationary pressures, lead to larger budgetary deficits for the federal government and some of the provinces, and result in additional pressures on the balance of payments. These problems require structural solutions. Structural change requires time and patience for relative price changes and market realities to manifest themselves; yet the waste of persistently underutilized labour and capital resources is unacceptable. A slack economy may impose market discipline on some economic agents, but it also fosters protectionism and pessimism. A period of protracted uncertainty produces calls for government leadership and intervention, but there is also a broadly held view that the kinds of structural problems that Canada faces require aggressive initiatives from the private sector. In this chapter, the Council offers its view on an appropriate balance of policies. In general, we propose that governments should move rather carefully to maintain adequate growth in aggregate demand, while moving more vigorously to encourage needed structural change through incentives and improved mechanisms for consultation on basic economic issues.

Structural Problems

International Competitiveness and . . .

Canada's share of world exports of manufactured goods continues to decline, and this lagging competitiveness is an object of deep concern. Manufacturing unit costs have risen much more rapidly in this country than in the United States, and average hourly earnings in Canadian manufacturing are now among the highest in the world.¹ Because this unfavourable gap in unit costs has recently narrowed and the value of the Canadian dollar has dropped, much of the trade disadvantage will be offset, at least in the short run. But more fundamental domestic cost reductions and marketing initiatives are needed if Canadian exporters are to recapture the ground they have lost.

The continuing preference of Canadians for imported manufactured goods constitutes a further strain on the trade balance. Although sluggish recovery had caused import expenditures to level off even before the fall of the Canadian dollar, the volume of manufactured imports as a percentage of domestic consumption has risen steadily since the early 1960s and, despite a temporary downturn, we expect this trend to continue.

On a broader front, it seems clear that the growth of the developing nations will call for a substantial increase in trade and offer opportunities for Canadian exports of agricultural and other primary and semiprocessed products, as well as some heavy equipment and capital-intensive manufactured goods. In return, Canadians must expect to import increasing amounts of manufactured items with a relatively high labour-intensive content. Enhancing the competitiveness of the economy will require substantial capital to modernize existing plants and modify the industrial structure in line with the nation's advanced technological know-how and natural resource base. It may also require more specialization in somewhat fewer products, in order to gain wider access to export markets. These developments will also necessitate measures to minimize and to distribute the costs of adjustment of low-productivity firms in such areas as textiles, footwear, and electronic products, which will likely have difficulty competing and which are often the sole or major employer within a community.

. . . Industrial Adaptation

It is not enough for Canadians to wait patiently for renewed dynamism in foreign markets, to pressure their governments for import restrictions or, alternatively, to let the competitive cut and thrust of market forces

¹ In some other western nations, wages and labour costs have risen even more rapidly than in Canada; usually, however, this has been accompanied by a depreciation of their currency even more extensive than Canada's.

perform its surgery. We believe that, as a first step towards strengthening Canada's economic competitiveness, a closer federal-provincial concertation of industrial strategies is required. We take this view because the corporate pursuit of profit is not always consistent with the most efficient or equitable use of scarce resources. Metropolitan markets, through their size alone, lure many manufacturing enterprises; jobs are thus created, and urban and suburban populations expand. The social costs that are generated, however, may not be borne by the enterprises — utilities, roads, schools and other services that call forth government expenditures and taxes of a scale that might have been avoided had the private investment been made elsewhere or at a different time.² Cities, towns, and provinces naturally vie with one another for industrial expansion and the employment opportunities that it brings. The ultimate result, however, must reflect proper acknowledgment of all the costs, if the twin concerns of market competitiveness and public well-being are to be preserved.

Several provinces have developed, or are developing, their own industrial strategies; and most provincial departments of trade, industry, or economic affairs are continuously making concrete arrangements with investors and private businessmen pertaining to the location and scale of industrial activity and employment within their jurisdiction. The federal government also has major responsibilities in these areas. Its trade and tariff regulations themselves constitute a form of industrial strategy, as do its various industrial incentives and corporate tax provisions. In addition, the Department of Industry, Trade and Commerce has for some years been working on an overall industrial and investment strategy for Canada, but this plan has not yet been fully articulated.

We have observed that the objectives of separate industrial development programs, as well as the regulations and incentives of each level of government, can sometimes be in conflict, even self-defeating, and that they are not necessarily in the overall public interest. The achievement of reasonably integrated policies will not come easily. The discussion, during the latest federal-provincial meeting of trade and finance ministers, of issues associated with the multinational trade negotiations now under way in Geneva is a step in the right direction, but a much greater harmonization of policies is needed, embracing the full range of responsibilities in financial and regional matters, as well as in the area of manpower and related policies.

The Balance of Payments and Foreign Borrowings

Canada has traditionally been unable to generate enough domestic savings to finance its industrial expansion and plant modernization while

2 Economic Council of Canada, *Toward More Stable Growth in Construction* (Ottawa: Information Canada, 1974), Chapter 7.

simultaneously maintaining and improving educational, health, defence, and other publicly financed facilities. Foreign investment has raised Canadian productivity and real wages by increasing the amount of capital per person employed and effectively transferring income from abroad to Canadian workers and consumers. This, of course, has also brought about a high degree of foreign ownership in Canada's industrial structure — ownership that seems to be concentrated in the larger capital-intensive sectors.

There are now, however, indications that Canada is no longer perceived to be the favourable destination for foreign equity capital that it once was. The unenthusiastic response of Japanese businessmen to recent overtures by the premier of Ontario is but one example. Uncertainty about the continued unity of the country, along with the regulations imposed by the Foreign Investment Review Agency (FIRA), may also have discouraged some foreign investors from purchasing Canadian securities.

Earlier in this *Review*, we noted the diminution in the inflow of equity capital from abroad — indeed, there has been a net repatriation of capital — and a much greater reliance on debt borrowing. The outcome of this trend — particularly evident in recent years — has been a heavy overhang of debt service payments, most of which are payable in the currency of the lenders. These developments are worrisome. While the switch in corporate financing from equity to debt borrowing involves no change in ownership, debt repayments have contributed seriously to the widening current account deficit. We therefore believe that it is important for Canada to encourage foreign investors to put their capital into Canadian enterprises. Such encouragement should not, of course, be at the expense of anti-pollution, health and safety, or other regulations that are applicable to all corporate firms and are essential to the quality of life.

In earlier periods of balance-of-payments difficulties, the federal government sometimes imposed temporary surtaxes on selective imports and foreign-exchange limitations on private travel. We do not consider this type of market interference to be warranted at this time. We believe, however, that governments at every level should consider ways of reversing the present deteriorating trend of the balance of payments. This might involve specific incentive measures for the Canadian tourist industry and for some other export-oriented or import-competing enterprises — measures that should not run counter to the objectives that Canada seeks to achieve through the GATT negotiations. Also, it could involve a federal-provincial review of the prospects, procedures, and forms of foreign borrowing — a review that would go somewhat beyond the recently suggested federal-provincial harmonization of major borrowings.³ For, as the projections derived from the CANDIDE simulations show,

3 See Judith Maxwell, *Policy Review and Outlook, 1977: An Agenda for Change* (Montreal: C. D. Howe Research Institute, 1977), p. 119.

unless an extraordinary change occurs both in the patterns of savings and expenditures of Canadians and in this country's international competitiveness, heavy reliance on foreign borrowing to offset large current account deficits will probably continue well into the 1980s.

Unemployment

Canada's high average hourly earnings would normally imply a relative scarcity of labour but, in fact, this country still exhibits the most rapid labour force growth of any major western nation. The numbers of married women and young people have grown the most, and their contribution to family income has been considerable. Despite the rise in prices and the uncertainties and confrontations that have marked the 1970s, real gains in family and average personal income have never been higher. At the same time, however, the Canadian economy has been unable to generate enough new jobs to match the total growth of the labour force and to achieve the stipulated targets of lowered unemployment through conventional means. Almost inevitably, the increased availability of jobs has induced a large number of persons previously attending school or otherwise not looking for work to enter the labour market.

Unemployment is presently, and will continue to be for some time, concentrated disproportionately among young people. Half the 890,000 Canadians who were out of work in September 1977 were under age 25. While, in many cases, this reflects job shopping, coupled with part-time or occasional attendance at educational institutions, there are scores of young people who simply cannot secure full-time jobs.

Even with the measures recently announced by the Minister of Finance,⁴ the unemployment rate will continue to be very high, despite a projected real growth rate that, by international or historical standards, is quite good. Although unemployment does not impose the financial hardship that it used to, continuation of such a high level is not a prospect that Canadians would easily accept. The problem is rendered more difficult by the uneven pace of regional economic growth and the persistence of chronically high unemployment and underemployment in many areas of the Atlantic provinces and Quebec and in the rural and northern regions of Canada.

The solution is more jobs. In principle, we believe that these jobs should be found mainly in the private sector and linked closely to consumer needs and tastes. For this, Canada needs more employment-creating investments. The economy's natural advantage lies with resource-based industries, but these are not labour-intensive. The mining industry, in

⁴ The Honourable Jean Chrétien, *Economic and Fiscal Statement*, October 20, 1977 (Ottawa: Supply and Services Canada, 1977).

particular, is languishing. While manufacturing is more labour-intensive, employment there has in fact been diminishing. On the other hand, the growing demand for services — the sector that has provided most of the new jobs over the past two decades — depends on continued increases in real incomes, which result mainly from rising productivity in the primary and secondary industries but also from government spending, which is now constrained.

A year and a half ago, in our study of labour markets,⁵ we called for a program of auxiliary jobs to be supported by federal wage subsidies and administered by public and private organizations serving identifiable community needs. Such a program, we stressed, would be preferable to paying unemployment insurance. To a considerable degree, the present Canada Works Program reflects the approach and ideas developed in our proposal. Yet, despite the existence of that program, along with Young Canada Works and other federal and provincial programs, the high levels of unemployment have not abated — hence the need for additional initiatives such as those just announced by the Minister of Finance.

The option of offering firms a system of employment incentives — as distinct from investment incentives — in the form of tax credits for jobs created for the unemployed is not a new concept. Ontario and Manitoba have direct job-creation programs involving wage subsidies. Also, in the 1971 federal special employment plan, employers who had created jobs for on-the-job trainees had the option of being reimbursed either directly or through tax credits. Because of their cash-flow situations, almost all firms chose direct funding. Such programs are effective, although they carry administrative problems for both the employers and the government, not the least of which is to ensure that tax credits are applied to genuinely new jobs that the employer would not have created otherwise. An alternative possibility, aimed principally at unemployed youth, would be for the provincial and federal governments to widen their minimum-wage differentials applicable to adult and young workers in order to encourage employers to hire more young people. This approach also is not without shortcomings, in that relatively few industries pay only the legislated minimum wages. Moreover, a recent study conducted in the United States indicates that no matter what incentive is offered to employers, there is a fairly high degree of labour substitution; for example, the authors estimate that, in some states where minimum-wage differentials have been widened, five adults have been displaced or not hired for every eight young people added to payrolls.⁶

5 Economic Council of Canada, *People and Jobs: A Study of the Canadian Labour Market* (Ottawa: Information Canada, 1976), p. 46.

6 The Conference Board, *Employment and Unemployment: Priorities for the Next Five Years* (New York, 1977), p. 31.

If our projections are correct, the extra \$150-million federal winter works projects and the new \$100-million employment credit program — two measures announced by the Minister of Finance in October — will not be sufficient to bring about the reduction in either youth or adult unemployment that is needed. Additional measures, at both levels of government, are likely to be necessary in both 1978 and 1979.

Energy Conservation

Rising energy costs constitute a further problem. It is not just a matter of Canada's position shifting from that of a net exporter of crude petroleum to that of a net importer, with the additional balance-of-payments burden that this entails. Rather, because Canadians have long had easy access to low-priced energy, they have become one of the most wasteful energy-using nations in the world. In order to encourage energy conservation, it is essential that Canada's petroleum and natural gas prices soon reach parity with world prices. Policymakers must be aware, however, that this will add inflationary pressures and place a further cost burden on regions and industries that are major users of oil and gas.

The shift to a conserver society will not be easy. It is not clear, for instance, what role governments should play in encouraging — indeed requiring — new and old houses and nonresidential structures to carry adequate levels of insulation, or in regulating the levels of heating or of electrical power used by individuals and firms. Nor is it clear where the line between public and private interest lies in such matters as the use and size of automobiles, waste recycling, and the choice of industrial fuels. We need better understanding as to who should shoulder the costs of conservation and also as to where and to what extent governments should legitimately intervene. Hopefully, much can be accomplished through traditional pricing mechanisms and through public education and corporate initiatives.

Intensifying the Effort

Most economic recoveries feature an upward shift in exports and personal consumption, depleted inventories, sustained increases in productivity, and business optimism — all factors that lead to renewed investment and lower unemployment. The present recovery has shown a noticeable lack of these phenomena. Even with the set of stimulants introduced by the Minister of Finance in October, the outlook for the next five years, as we perceive it, is for relatively modest growth, persistent inflation, high unemployment, and very large current account deficits. Our examination of alternative fiscal and monetary policy options in Chapter 5 suggest

that it may not be possible to improve the performance of the economy on all these fronts simultaneously. To achieve reasonably sustainable economic growth will require a balancing of objectives. The room for manoeuvre by the federal and most provincial governments is limited by financing constraints, and policymakers will continue to be faced with restricted options in selecting a policy mix that, hopefully, will propel the economy along a more desirable growth path.

The federal government's announcement of the phasing-out of controls after April 14, 1978 has helped to ease some of the uncertainty facing businessmen and organized labour. While we are not overly optimistic about the reduction in the inflation rate that is likely to result from a continuation of controls well into 1978 and the operations of a monitoring agency thereafter, it is assumed, in the various scenarios described in Chapter 5 and in the projections developed by most medium-term forecasting organizations, that there will not be a renewal of severe inflationary pressures as a result of the removal of controls.

Monetary Policy

Over the past three decades, governments in all industrialized countries have gradually assumed responsibility for economic management in order to reduce the amplitude and severity of business cycle fluctuations. In the process, citizens and interest groups have come to expect continual improvements in real incomes. Since incomes depend on the prices of the goods and services produced, countervailing mechanisms have developed that are intended to offset or cushion a decline in prices. Such elements are built into the systems of industrial relations, mark-up pricing practices, marketing boards, equalization payments, indexing, and so on. Their existence exerts an upward bias to price changes. And governments, too, can contribute through excessive spending. When the stance of monetary policy facilitates this process, there is virtually no escape from successive rounds of inflationary pressures. Conversely, firm control over the growth of the money supply may induce the various interest groups in the economy to contain their competing claims for income shares.

Some monetary growth is, of course, needed to accommodate the increase in economic activity. The trick is to ensure that the monetary policy is not so tight as to inhibit the investment and expenditures necessary to sustain high levels of economic growth and employment nor so permissive as to generate inflation, which undermines the real value of people's savings and the purchasing power of their incomes.

The monetary policy followed by the Bank of Canada has broad support at present. Hence, with world prices predicted to fall slightly next year,

with the federal deficit remaining very large, and with controls being phased out,

Recommendation 1

We recommend that the Bank of Canada maintain its present policy of limiting the growth of the money supply and that, as inflation rates fall, the Bank continue to shift the target rate downward.

Fiscal Initiatives*

In the absence of business confidence, the use of monetary instruments alone to stimulate the economy has been described as "pushing on a string." Stronger measures are needed to revitalize the economy. The overall growth rate of the economy projected in our reference solution (see Chapter 5) — which embodies the latest federal initiatives but no additional measures — will barely prevent the currently high unemployment rate from increasing further. This unpromising outlook led us to consider the introduction of additional fiscal incentives in 1978 and 1979 that would allow the economy to perform more strongly then and in subsequent years.

How would this revitalization originate? Despite the corporate tax incentives contained in the March 1977 budget and reaffirmed in the October statement by the Minister of Finance, a resurgence of investment is not likely to occur until there is greater recovery of demand. Improved export markets have helped, but most of the export sectors were already working from depressed capacity utilization rates, and the base metals sector is still depressed. Canada, along with other OECD countries, is committed to harmonizing demand management internationally to reinforce national initiatives. This will require a further major increase in either consumer or government purchases, but it is our view that the stimulant should not come from increased government spending. On the contrary, we believe that consumer confidence and consumer purchasing power must be restored, thus creating a more favourable market for output and for new investments. As we extend our perspective towards future government budgets, we believe that, even after the stimuli imparted by the recently announced tax cuts take hold, other permanent tax cuts will be warranted. The objective should be to increase the after-tax real income and spending capacity of individuals and families, while keeping wage demands consistent with the need to improve Canada's competitive cost structure.

*M. Bélanger and R. M. MacIntosh feel that, in a world economy adjusting to slower growth rates as a result of higher energy costs, further stimulative fiscal policies would be counterproductive because they would not address the problem of bringing the Canadian economy back to a competitive position.

What form should the stimulus take? While many possibilities suggest themselves and others will emerge, the main areas that we explored were in the fields of personal income tax and provincial sales taxes, government spending, and monetary policies. The use of an expansionary monetary policy alone would have immediate inflationary consequences and would lead to further deterioration of the Canadian dollar to well below \$U.S. 0.90. The 1977 investment incentives seem adequate for the time being and, while we gave some thought to reductions in the federal sales taxes on manufactured items, it was felt that these would not provide the same immediate, widespread, contra-inflationary effect that reductions in the provincial sales taxes offered.

Some thought was given to increased government expenditures, particularly in the area of public works, to increase growth. Private non-residential construction has dropped off substantially, and increased public construction expenditures would provide jobs. But, with a recovery in 1978 and with private nonresidential investment expected to follow — most notably the natural gas pipeline and other energy-related projects — the idea was put aside because of the time that would be required for governments to mount additional projects, and public misgivings over the size of government expenditures. This left the field to personal income tax and provincial sales tax reductions.

In framing a fiscal recommendation, we assume that the federal government will succeed in restraining its expenditures and shifting some resources to the provincial and private sectors. Our estimates in Chapter 5 (see also the appendix table) indicate that, even with the impetus imparted by the tax cuts announced in March and October, the unemployment rate could remain above 8 per cent into the 1980s. While the economic performance would be stronger than that of the past three years, it would not be up to full capacity nor would it meet the expectations of most Canadians. Hence we believe a further permanent reduction in personal income taxes may well be called for in the next round of federal and provincial budgets.

How large should the tax cut be? Various formulas could, of course, be adopted. In the Chapter 5 simulations, we applied a flat 8.3 per cent reduction of tax rates across the board, combined with a 25 per cent reduction of the rates paid by people in the lowest income bracket. We estimated that tax cuts of this magnitude would increase real growth in Canada by close to 1 percentage point in 1978 and reduce the unemployment rate to 7.7 per cent. There would be a very modest inflationary effect — one-fifth of one percentage point — and some increased pressure on current account balances. But these do not, in our view, warrant rejecting the tax cuts or combining them with a more restrictive monetary policy. Indeed, a tighter monetary policy could abort the initial stimulus that we hope to achieve.

We are aware, of course, that this call for action to improve Canada's economic performance will require the financing of substantial government deficits. Without minimizing the debt-management problems involved, we believe this task is feasible. Consumer saving will be relatively high, and the business sector will be in a relatively liquid situation. Provinces receiving oil and gas royalties will have considerable funds for investment. It also seems likely that international investors will continue to be attracted to sound portfolio investment opportunities in Canada, although these funds are very sensitive to interest-rate differentials. While predicted federal borrowing requirements are high in absolute terms, they do reflect a shift of tax revenue to the provinces by the renegotiation of fiscal arrangements in 1977 and the payment of accrued interest on Canada Savings Bonds. The former will have the effect of reducing provincial borrowing requirements, and the latter will mean that individuals will have more funds to invest in government bonds. Moreover, a successful strategy of stimulation will gradually raise federal government revenues at a faster rate than that of real GNP growth and help to reduce the budgetary deficits that the federal and some provincial governments are now experiencing. But, because of the possible inflationary pressures that the financing requirements might generate, we have been led to be relatively cautious in our recommendations.

We assume that all provinces would endorse the purpose of, and share in, the reduction of revenue associated with the suggested overall tax cut. To the extent that provincial personal income taxes in all provinces except Quebec are calculated as a percentage of the federal basic tax, a reduction in federal rates implies a corresponding reduction in provincial income tax revenues. This is an area in which the tradition of co-operation and exchange among federal-provincial finance ministers will be helpful. In this connection, we believe that there is room for a more flexible federal-provincial fiscal stabilization approach so that the stimulus imparted could be greater in those provinces that traditionally have high and persistent unemployment rates and lower-than-average incomes per capita. But precisely how the tax reduction should be applied at different income levels is a matter for fiscal experts, who must balance the needs and higher spending propensities of low-income groups against the desire for tax relief among middle- and upper-income groups. Therefore,

Recommendation 2

We recommend that, over the next two fiscal years, the federal and provincial governments implement permanent personal income tax cuts that would increase the annual disposable incomes of consumers by a total of \$2 billion in addition to reductions resulting from indexation.

The foregoing recommendation, when fully implemented, would be equivalent to an 8-to-10 per cent reduction in personal tax rates and would

provide ongoing stimulus to consumer purchasing power equivalent to about \$200 per taxpayer per year. It assumes, of course, that the federal and provincial governments will adhere to their commitments to restrain spending.

Provincial sales taxes are a second area in which we believe cuts could be made, because these would provide additional stimulus to consumer expenditures through lower prices. The extent to which provinces could accommodate revenue losses on both income and sales taxes will, of course, vary with each province, and it is doubtful whether any across-the-board formula ought to be considered. While most provincial governments are currently in a budgetary deficit situation, mainly because of the slow growth of their economies, some are in better financial shape than the federal government. By implementing a significant reduction in provincial sales tax rates, they could lower prices, stimulate expenditures, and reduce the tax burden of low-income households. Indeed, if both the personal income and the sales tax initiatives were in effect throughout 1978, this would result in a substantial increase in real disposable income and strengthen the economic outlook in subsequent years. Therefore,

Recommendation 3

We recommend that provinces reduce their sales taxes by at least 1 percentage point on taxable consumer goods and services other than such items as gasoline, alcohol, and cigarettes.

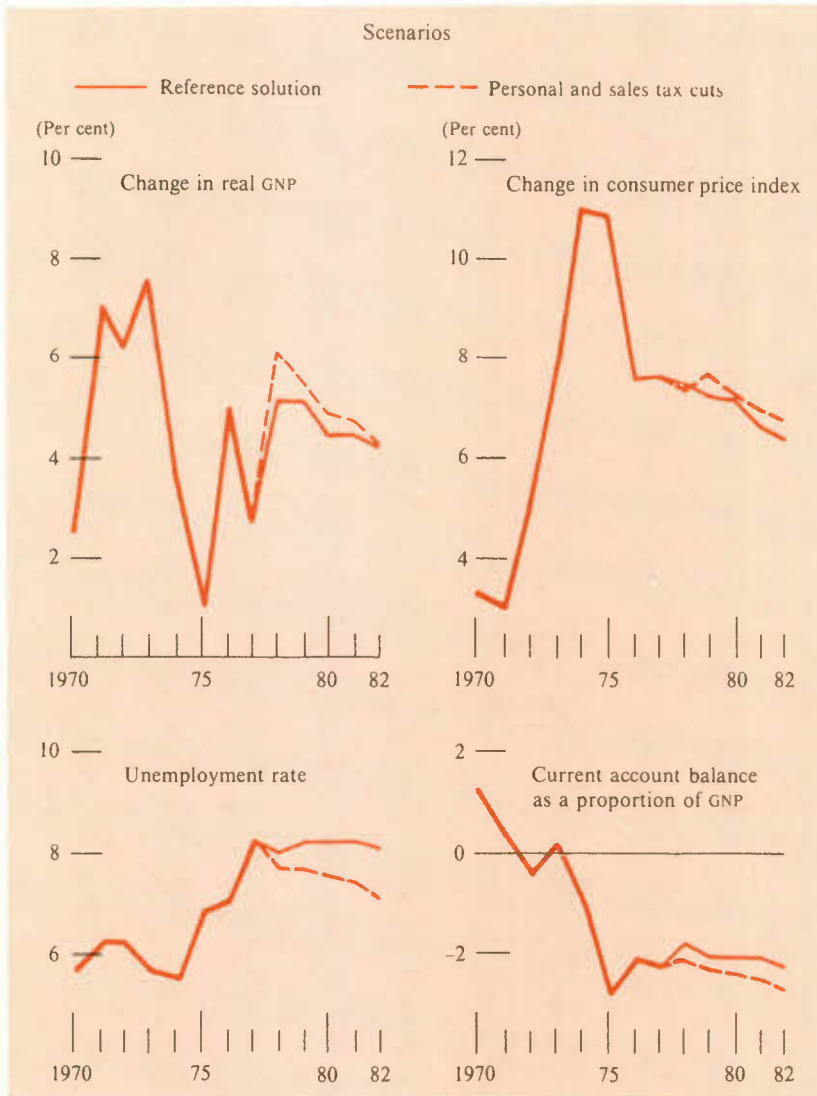
What we are calling for obviously represents a dramatic transfer of resources, by both levels of government, back to the taxpayer for the express purpose of quickly restoring consumer confidence and stepping up the pace of business activity. If provincial sales taxes were cut by the amount recommended, the combined provincial revenue loss would be about \$1 billion — an amount slightly less than the corresponding federal loss. The combined tax cuts would require larger offerings of bonds and an increase in government borrowings. Assuming the tax cuts were permanent, however, the strengthened economic performance well into the 1980s would help restore much of the forgone tax revenues through growth in sales, employment, and income (Chart 6-1).

Since the publication of our study of regional disparities,⁷ in which we advocated a more carefully chosen mix of federal policies and the pursuit of more consciously contracyclical fiscal policies by each province, there has been a significant shift of tax revenues from federal to provincial jurisdiction. Moving into 1978 and beyond, we expect that the provinces and the federal government will want to reach understandings about the

⁷ Economic Council of Canada, *Living Together: A Study of Regional Disparities* (Ottawa: Supply and Services Canada, 1977).

Chart 6-1

Change in Selected Indicators in Two Medium-Term
Scenarios, CANDIDE Model 1.2M, 1970-82



SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada.

degree of stimulus needed in each province and the allocation of responsibility for achieving it. The practical realization of such understandings and the conclusion of formal arrangements will likely require significant changes in federal-provincial relationships.

Many options warrant re-examination. For instance, the federal government could enlarge the market for provincial securities by inducing the Bank of Canada to purchase part of certain issues of provincial government bonds and by allowing chartered banks to hold them as part of their secondary reserves. Equalization payments could be made more sensitive to the specific capabilities and needs of individual provinces to stimulate local demand. Moreover, there is the possibility of reallocating the additional tax yields and savings in transfer payments that result from more appropriate demand management in individual provinces. In a broader sense, new constitutional relationships are being sought in order to give better expression to the basic economic aspirations of all Canadians in all provinces or regions.

New Consultation Initiatives

Most of the issues examined in this *Review* are interrelated and complex; they spring from root changes within the economy and from the altered moods and attitudes of Canadians, who have experienced a rather unique combination of slowdown, inflation, and price and wage controls.

As the economy approaches and enters the 1980s, the more effectively Canadians can resolve short-term difficulties, the more directly they will be able to confront the structural questions. One thing is sure: the simultaneous achievement of all the nation's various economic objectives is not possible; indeed, the resolution of one problem will likely raise others. There are genuine conflicts of interest among different regions, and competing claims to the nation's wealth. Therein lies the challenge for each generation.

Thus, apart from the matter of federal-provincial concertation, the very plurality of interests and cultures that contributes to the country's underlying strength calls for better mechanisms of consultation between governments, producers, consumers, and other groups. The complexity of issues and the diffuse way in which the costs and benefits of public and private actions are spread necessitate dialogue and compromise on many issues.

It is recognized, of course, that a great deal of consultation already exists and that Members of Parliament are interacting continually with their constituents. Also, there are already numerous organizations advising federal departments. Many of these relationships, however, are rather narrowly based and are not fully representative of both consumer and producer concerns. Therefore,

Recommendation 4

We recommend that the federal government, together with representative organizations, establish appropriate advisory and consultative mechanisms (with adequate staff resources) to examine serious long-term structural issues.

Conclusion

It is possible to move the economy back to a more desirable growth path, but this will require structural change as well as demand stimulation. Even with the initiatives that we are suggesting, unemployment rates will probably not fall below 7 per cent until after 1980. Inflation will persist roughly in line with the inflation rates of Canada's major trading partners. Without improvement in this country's capacity to control costs and improve productivity, we face the prospect of persistent overall government deficits, no improvement in current account balances, and rising foreign indebtedness. Neither federal nor provincial governments will have much flexibility for new expenditure programs. A concerted effort to improve the structure of the Canadian economy over the medium term is obviously needed.

The Council believes that Canadians and Canadian institutions can cope with the challenges foreseen. This task will require a realistic assessment of problems; it will require imagination to perceive opportunities; it will require confidence to achieve change; and it will require greater trust and understanding among the different groups in the Canadian economy.

Appendix Table

Selected Indicators Associated with
Alternative Policy Scenarios, 1978-82

	1978	1979	1980	1981	1982
(Percentage increase)					
Real gross national expenditure					
Reference solution	5.1	5.1	4.4	4.4	4.2
Personal tax cuts and higher government spending	6.3	5.8	4.8	4.8	4.4
Personal tax cuts and sales tax reductions	6.1	5.4	4.8	4.7	4.3
Personal tax cuts only	5.9	5.3	4.7	4.7	4.3
Personal tax cuts and tighter monetary policy	5.9	5.1	4.4	4.3	3.9
Restrictive monetary policy	5.1	4.9	4.1	4.0	3.8
Expansionary monetary policy	5.3	5.5	4.8	4.9	4.7
(Percentage of labour force)					
Unemployment rate					
Reference solution	8.0	8.3	8.3	8.3	8.1
Personal tax cuts and higher government spending	7.5	7.4	7.2	6.9	6.6
Personal tax cuts and sales tax reductions	7.7	7.7	7.6	7.4	7.1
Personal tax cuts only	7.7	7.8	7.7	7.5	7.2
Personal tax cuts and tighter monetary policy	7.8	8.1	8.0	8.0	7.9
Restrictive monetary policy	8.2	8.5	8.6	8.7	8.7
Expansionary monetary policy	7.9	8.0	7.8	7.6	7.2
(Percentage increase)					
Consumer price index					
Reference solution	7.4	7.2	7.1	6.6	6.3
Personal tax cuts and higher government spending	7.6	7.6	7.4	7.0	6.8
Personal tax cuts and sales tax reductions	7.3	7.6	7.3	6.9	6.7
Personal tax cuts only	7.6	7.7	7.3	6.9	6.6
Personal tax cuts and tighter monetary policy	6.8	7.2	7.0	6.7	6.4
Restrictive monetary policy	6.7	7.0	6.9	6.5	6.2
Expansionary monetary policy	8.1	7.9	7.9	7.1	6.7

Appendix Table (concl'd.)

	1978	1979	1980	1981	1982
	(Percentage increase)				
Real disposable income					
Reference solution	3.5	4.2	3.5	4.0	3.7
Personal tax cuts and higher government spending	5.7	4.7	4.1	4.5	4.1
Personal tax cuts and sales tax reductions	6.0	4.2	4.0	4.3	3.9
Personal tax cuts only	5.4	4.3	4.0	4.3	4.0
Personal tax cuts and tighter monetary policy	6.0	4.0	3.6	4.0	3.6
Restrictive monetary policy	3.9	3.8	3.3	3.7	3.4
Expansionary monetary policy	3.1	4.4	3.7	4.6	4.2
	(Percentage of GNP)				
Current account balance					
Reference solution	-1.8	-2.1	-2.1	-2.1	-2.3
Personal tax cuts and higher government spending	-2.2	-2.6	-2.7	-2.8	-3.1
Personal tax cuts and sales tax reductions	-2.2	-2.4	-2.5	-2.6	-2.8
Personal tax cuts only	-2.1	-2.3	-2.4	-2.5	-2.8
Personal tax cuts and tighter monetary policy	-2.2	-2.5	-2.5	-2.4	-2.5
Restrictive monetary policy	-1.9	-2.2	-2.1	-1.9	-2.0
Expansionary monetary policy	-1.7	-2.0	-2.0	-2.2	-2.6

SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada.

Tables

1-1	International Comparison of Selected Energy Prices, April 1977	7
1-2	Change in Consumer Price Index, Canada, January-August 1977	9
1-3	Labour Market Indicators, Canada, 1974-77	10
1-4	Unemployment, by Age-Sex Group, Canada, 1961 and 1977	10
1-5	Duration of Unemployment, Canada, by Province, 1977	11
1-6	Average Income of All Families and Unattached Individuals, 1975 and 1976	12
1-7	Income per Capita and per Employee, Canada, by Province, 1971-75	13
2-1	Approval by the Anti-Inflation Board of Salary Increases Submitted above the Arithmetic Guideline, by Program Year, to September 23, 1977	17
2-2	Increase in Base Wage Rates over Life of Collective Agreements, 1973-77	18
3-1	Current Account Balance, Selected Years, 1961-77	30
3-2	Trade Balance, Selected Goods and Selected Years, 1971-76	33
3-3	Average Tariffs on Selected Imports, Major Industrial Countries, 1977	40
4-1	Gross Private Savings and Its Major Components, as a Proportion of Gross National Product, 1961-76	49
4-2	Investment as a Proportion of Gross National Product, and Real Annual Growth Rate of GNP, Seven Industrial Countries, 1961-76	50
4-3	Capital Inflows and Outflows, Canada, 1950-76	54
4-4	New Canadian Security Issues, by Source and by Destination, 1952-75	56
4-5	Distribution of Change in U.S. Direct Investment in Canada, by Industry, 1952-73	59
4-6	Net Increase in Book Value of Foreign Direct Investment in Canada, 1965-76	60
4-7	Balance of International Indebtedness, Canada, Selected Years, 1950-76	62
5-1	Assumptions about the External Environment, CANDIDE Model 1.2M, 1978-82	67
5-2	Assumptions about the Domestic Environment, CANDIDE Model 1.2M, 1978-82	67
5-3	Major Indicators in Medium-Term Economic Policy Scenarios, CANDIDE Model 1.2M, 1977-82	70

Appendix Table

Selected Indicators Associated with Alternative Policy Scenarios, 1978-82	92
---	----

Charts

1-1	Annual Change in Real Gross National Expenditure, Canada, 1972-77	2
1-2	Cyclical Developments in Productivity Index, Major Industrial Countries, 1973-76	3
1-3	Annual Unemployment Rate and Annual Change in Productivity and Real Disposable Income per Capita, Canada, 1961-76	4
1-4	Year-over-Year Change in Selected Components of Consumer Price Index, by Quarter, 1971-77	6
1-5	Production and Consumption of Oil and Gas, Canada, 1960-77	8
2-1	Actual and Projected Average Increase in Base Wage Rates in Major Collective Agreements, Fourth Quarter 1975 to First Quarter 1977	20
2-2	Year-over-Year Change in Monetary Aggregates, by Quarter, 1970-77	22
2-3	Exchange Rate of the Canadian Dollar, by Quarter, 1971-77	24
2-4	Fiscal Position of Government Sector, 1970-77	25
3-1	Indexes of Export and Import Volume, Price, and Value, Selected Goods, 1971-76	32
4-1	Gross Private Savings as a Proportion of Gross National Product, Canada and the United States, 1960-77	46
4-2	Savings of Major Sectors as a Proportion of Total Gross Savings, 1960-76	47
4-3	Net Lending or Borrowing, by Sector, 1960-76	48
4-4	Rate of Investment as a Proportion of Gross National Product, Selected Industrial Sectors, Canada and the United States, 1960-76	52
4-5	Funds Raised by Major Nonfinancial Borrowers as a Proportion of Gross National Expenditure, Canada, 1971-76	57
4-6	Direct Foreign Investment Flows into Canada, 1960-76	58
4-7	Index of Net Change in Book Value of Direct Foreign Investment as a Proportion of Gross National Product, 1955-76	61
5-1	Change in Selected Indicators in Three Medium-Term Scenarios, CANDIDE Model 1.2M, 1970-82	72
6-1	Change in Selected Indicators in Two Medium-Term Scenarios, CANDIDE Model 1.2M, 1970-82	89

Project Staff

R. A. Jenness, Director

Research

J.-M. Cousineau
J. Fortin
D. W. Henderson
D. MacMillan
N. Mathieu

P. Robillard
T. T. Schweitzer
M. Simoneau
L. Wesa

J. R. Downs, Downs Reconn Ltd.
R. Lacroix, University of Montreal

Editors and Translators

M. Forand
J.-G. Guertin
G. Loubier

R. J. Lyle
J.-P. Vallée

Support Staff

L. Desforges
T. Hodgins
A. Martin

Y. Sawyer
C. Sigouin

HC/111/.E26/n.14

Economic Council of Canada
Into the 1980s

dhya

c.1 tor mai

