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Canadian economic performance at the end of the twentieth century

As the curtain comes down on the twentieth century and we move on to the next millennium, it is difficult to resist the temptation to be both retrospective and prospective.

Ask Canadians to think back and many will tell you that the economy and they, as individuals, have been through some difficult times.

Those with longer memories, however, will recall the remarkably positive climate between the end of the Second World War and the early 1970s. Canada came out of the war with a relatively strong economy compared with the ravaged European countries. Moreover, there were sizable and sustained gains in productivity through the 1950s and 1960s. These reflected the revolution in agriculture and the forced modernization and expansion of Canadian industry during the war as well as the rapid changes in technology and industrial processes that followed.

All this led to a substantial rise in Canadian standards of living instead of the post-war depression that many had feared. And despite the exodus of workers from agriculture, the overall unemployment rate remained low. At the same time, rapid economic growth generated rising tax revenues that governments could spend on an increasingly wider social safety net without taxpayers feeling much of a pinch.

Compared with this post-war prosperity, our economic performance over the subsequent quarter century has been the source of some disappointment and concern.

Various explanations have been advanced for this less-favourable record since the early 1970s. There are four trends in particular that I would highlight in this regard: high inflation in the 1970s and 1980s; large and rising fiscal deficits from the mid-1970s to the mid-1990s; a slowdown in productivity growth; and a decline in the prices of primary commodities.

Tonight, I propose to comment on these four trends and their effect on the economy over the past 25 years. Much of the sense of economic disenchantment that Canadians have been feeling in the 1990s has been related to the difficult process of reversing these trends or adjusting to them. Fortunately, considerable progress has been made on several fronts. Hence, there are grounds for optimism regarding Canada's economic future.

The harmful effects of high inflation

The rate of inflation which, after getting through some of the post-war bottlenecks, averaged just over 2 per cent in the period to 1972, more than tripled over the next two decades.

This pickup in inflation was not a uniquely Canadian phenomenon. In many countries, monetary policy had become too expansionary during the late 1960s. This partly reflected a misconception among policy-makers that, by fine-tuning the economy and taking advantage of a perceived trade-off between employment and inflation, overall economic well-being could be improved.

One of the initial consequences of this accumulating worldwide monetary stimulus was a sharp rise in the prices of oil and other primary products in the early 1970s. Countries, like Canada, which are major producers of such commodities, experienced a surge in income and wealth. But they also faced strong demand pressures and rising inflation. In Canada, the surge in inflation was especially dramatic, reaching 12 per cent in 1974.

Once inflation had risen to those levels, it was very difficult to reverse. With each passing year, expectations of ongoing high inflation became increasingly entrenched.

High inflation exacts a heavy toll on an economy by making the future particularly uncertain. Long-term financing becomes less available and more costly as interest rates go up because of inflation and the higher risk premiums that lenders demand as compensation for the increased uncertainty. Inflation diverts resources away from productive investments into speculative ventures in real estate and other financial assets. And in its interaction with the tax system, high inflation encourages businesses to increase debt. These are the very types of excesses that lead to, and indeed aggravate, the economic busts that inevitably follow. During the 1970s and 1980s, Canadians had first-hand experience with such complications.

The impact of persistent government deficits and rising debt

High inflation was also partly responsible for the move towards larger government deficits in Canada that began in the mid-1970s.

Initially, inflation tended to generate increased revenues for governments, and this encouraged additional spending. When the effects of inflation became more evident, however, public pressure led to the indexation of the personal income tax system and the growth in government revenues slowed. Unfortunately, this was not offset by a tighter grip on spending.

For the government sector as a whole in Canada, on a national accounts basis, total program expenditures (not counting debt-servicing costs), rose from 37 per cent of gross domestic product (GDP) in 1975 to a peak of 43 per cent in 1992 (a year of recession). Over the same period, the budget deficit more than tripled to 8 per cent of GDP. And the ratio of outstanding net debt-to-GDP soared from less than 10 per cent to 60 per cent, and by the mid-1990s it had climbed to 70 per cent.

Increasingly, through the late 1980s and early 1990s, the growth in government spending raised concerns about whether this represented the most efficient use of the economy's resources.

From a policy perspective, the greatest concern was that persistent large deficits were pushing Canada's debt-to-GDP ratio to unsustainable levels and driving up risk premiums in our interest rates.

The economic costs of Canada's rising indebtedness became very clear after 1991, when our inflation rate came down quickly, but medium- and longer-term interest rates were slow to respond. One important reason for that was the persistence of high risk premiums because of fears that governments might be tempted to reduce the debt burden through inflation -- in effect, by printing more money. Canada's vulnerability to such concerns became particularly evident during the Mexican currency crisis.

High interest rates meant that we had to pay more of our income to foreign holders of our public and private sector debt. This made us poorer as a nation. And these high rates discouraged investment which, to some extent, relates to the third 'disappointing' trend of the past quarter century -- the slowdown in productivity growth.

The slowdown in productivity growth

Productivity has been at the centre of many public discussions in Canada recently. For good reason, too, since productivity is critically important to growing incomes and rising standards of living over time.

Unfortunately, such discussions are complicated by the fact that there is more than one measure of productivity, and there often seems to be some difficulty in distinguishing between the *growth* and the *level* of productivity. Things become even more complicated as one gets into cross-country comparisons.

After a strong showing from the end of the Second World War to the early 1970s, our productivity growth became lacklustre. Output per worker slowed from an average rate of about 3 per cent in the 1950s and 1960s to 1 per cent in the 1980s and 1990s.

Productivity growth also slowed in other industrial countries, including the United States, over this period. Indeed, average gains in labour productivity in the Canadian and U.S. business sectors have been roughly similar in the past 25 years. This means that the gap in productivity levels in favour of the United States has not really widened; but neither has it narrowed. Moreover, growth in U.S. productivity seems to have picked up strongly in the last year or so.

I do not have a complete explanation for the productivity slowdown in Canada. But I am prepared to assert that high inflation and the large fiscal deficits through most of the past 25 years were not conducive to productivity growth. They led to high interest rates and considerable uncertainty about the future -- both of which discourage the investment in technology and new equipment that helps to advance productivity increases.

Declining primary commodity prices

The final factor on my list is the decline in the prices of the key primary commodities that Canada produces.

Calculated from the early 1970s to the present, this decline amounts to some 45 per cent when the international prices of these commodities in U.S. dollars are adjusted for the increase in the general price level during this period. A drop of that magnitude in the prices of some of Canada's major exports is bound to have a significant effect on our standard of living.

To look at the past 25 years in isolation, however, tends to magnify the extent of the decline and leaves one with an exaggerated sense of the associated economic consequences. This is because commodity prices jumped to historical peaks at the beginning of the period, in response to the worldwide monetary stimulus that I mentioned, and remained generally high for nearly a decade or so, before reversing.

To put things in perspective, we need to focus on the longer-run behaviour of commodity prices. For only then does it become clear that these prices were exceptionally high through the first decade of this 25-year period, and that a good part of the subsequent downward movement represented a return to more "normal" levels. Indeed, between the late 1960s and the late 1980s, the level of inflation-adjusted commodity prices showed little change overall.

We should also keep in mind that part of the decline in commodity prices has reflected new discoveries of raw materials, more efficient ways of extraction, and reduced

production costs. Otherwise, we would have seen a much larger reduction in the importance of commodities, and in the profits and share prices of Canadian resource industries.

When one allows for some of these factors, the downward movement in commodity prices in the past 25 years is not as dramatic as it appears at first. But I can certainly appreciate that the sharp drop in these prices in 1997-98, associated with the Asian financial crisis, has had an especially strong impact on many Canadians' sense of well-being. Adjusted for inflation, commodity prices hit a new post-war low during this period and led to a substantial depreciation of our currency.

What does the future hold?

So far, I have argued that high inflation, large government deficits, slower productivity growth, and lower commodity prices have tended to complicate Canada's economic situation over the past 25 years. But as I said at the beginning, much of the greater sense of difficulty and concern that Canadians have felt in the 1990s has to do with the after-effects of the strong medicine we have had to take to turn our economic performance around. The success we have had so far in this regard bodes well for our future.

Canada's inflation rate has come down dramatically, averaging less than 2 per cent since 1992. And there are now agreed targets between the Bank of Canada and the Government of Canada to keep inflation low and stable in the future. More importantly, Canadians have come to expect continued low inflation and to build that expectation into their plans.

The federal government and most provincial governments now have balanced budgets or are running surpluses. The total government debt-to-GDP ratio, which peaked at 70 per cent in 1996, has since fallen to 63 per cent. With present prudent fiscal policies, it should continue to decline steadily.

Future gains in productivity are difficult to predict. Certainly, our improved inflation and fiscal situation, together with the low interest rates that they have made possible, provide the best climate for fostering productivity that we have had in a long time. Moreover, Canadian businesses have undergone major restructuring during the 1990s in response to increasingly competitive world markets. Business investment has been rising smartly recently and more firms have been adopting new production technologies.

It is also interesting to note that, after eight years of economic expansion, productivity growth in the United States has picked up, rather than falling off as usually happens at this stage of the cycle. Tight labour markets seem to have encouraged a record level of investment in that country and more efficient use of technology than before. While the pickup in Canadian investment in machinery and equipment has lagged somewhat behind that in the United States, new technology is not the exclusive preserve of our U.S. neighbours. So I hope that in

Canada, too, we will see a similar payoff from the adoption of new technology and a comparable improvement in productivity.

As for commodity prices, there has already been some turnaround this year, but a firmer recovery requires a strengthening world economy -- in particular, a turnaround in Japan and the rest of Asia.

The other point to note in this connection is that the relative importance of commodities in the Canadian economy has declined. The share of primary products in total Canadian exports has fallen from about 60 per cent in the 1970s and 1980s to about half as much presently.

I should also add that our flexible exchange rate system has been playing the role that it should in helping us adjust to lower commodity prices. The decline in the value of the Canadian dollar in 1997-98 was mainly a response to the impact of the Asian crisis on commodity prices. A weaker currency has helped to cushion the negative effect on our resource sector. But, more importantly, it has helped to stimulate demand for other Canadian exports and import substitutes, particularly of manufactured goods. In turn, this is encouraging a shift in production from commodities towards other tradable goods.

While I believe that this shift is exactly right for the Canadian economy, I do not agree with some recent suggestions that we should somehow force the pace of the movement out of primary products and into the so-called more modern, knowledge-based industries. If commodity prices do not recover from their current low levels and profits are squeezed as a result, this will happen naturally. But for now, primary products are still an important source of Canada's wealth and high standard of living, and they are likely to remain so for some time.

To conclude, the past 25 years have not been easy. And they have been less prosperous overall than many Canadians had come to expect, based on the experience of the 1950s and 1960s.

But, as we stand on the threshold of the next century, we can take comfort from the remarkable progress we have made recently in strengthening the foundations of our economy. This gives me reason to be positive about our capacity to improve our economic performance and to meet tomorrow's challenges with confidence.