CHECK AGAINST DELIVERY

Notes for an address by Andrei Sulzenko to the Kingston Chamber of Commerce on Canada's Future Growth Prospects

- We are all courageous for coming together this early in the morning to talk about economics, a.k.a. the dismal science; I hope everyone has had lots of coffee.
- For that we can thank Andrea Gunn who was one of my students in the Queen's MPA program last spring. My course was called Productivity and Competitiveness, and that's what I'm going to talk about today.
- The Finance Minister will provide the fall economic statement in a few weeks time.
- I'm not going to attempt to preview what he will say about the challenges facing the economy; in fact, last year's analysis would probably do well with a few updates.
- The problem is not one of analysis; I spent the better part of 10 years before retiring, providing a consistent analysis of the micro-economic issues.
- The problem is political interest in dealing with the long term, especially now when everything in Ottawa is so short term.
- But that was the case too under previous majority governments going back a dozen years.
- Why? Well, my theory has always been that politicians don't anticipate, they react. And over the last 10 years things have been pretty good on the economic side, so there has been no pressure (except from the business community) to deal with long term issues.
- The main exception to this was, of course, the slaying of the deficit, but in many ways that too was reactive, once we had our backs to the wall and were being compared to a third world country by the Wall Street Journal. We'll see if we need to be in the same position on climate change before a real plan is developed.
- To underline my point, look at the last election campaign. The economy was barely mentioned – and I don't consider the GST cut to be a real economic policy initiative.
- In fact, studies have shown that a one dollar reduction in GST has only a 10 cent benefit for economic growth, compared to say a dollar reduction in corporate tax which has a 90 cent return.
- Today too, the income trust issue aside, much of the economic focus is on tax cuts, mainly personal, but not for imperative economic policy reasons but because the federal government is collecting too much money and has to give it back through new spending, tax cuts or debt payment. A Conservative government prefers the last two.

- So why do I continue to be Chicken Little and point to a falling sky? Let me take you briefly through the analysis, and then I'll speak about what to do about it.
  - First, much of the 3% average annual growth over the last 10 years was driven by two factors that are more and more difficult to get more mileage from as we go forward:
    - trade, mainly huge export growth to the US market, aided by a low Canadian dollar and a voracious American appetite for imports (in fact notwithstanding this export growth, we barely held our own in terms of market share, against other countries selling into the US); and
    - employment growth in Canada was the highest in the G-7 group of economies for the better part of 30 years, and in the last 10 years employment accounted for about 30% of total growth in the economy – we were a veritable job machine mopping up a lot of unemployed and underemployed labour, while the US economy, with already high employment rates switched emphasis to productivity growth.

    As we go forward neither of these two main sources of growth is as easily available: exporting in anything but resources is tough into the US market because of the resource price-driven exchange rate, and we are not well-positioned in rapidly growing Asian markets relative to our competitors; and labour force growth is slowing dramatically to the point that it will turn negative in 5 years absent immigration.
  - Second, the cyclical rise in resource prices has masked our economic vulnerability, by maintaining our overall growth path, but that trajectory cannot be sustained in the long term. In this regard, manufacturing in Canada is taking a pounding as it struggles to adjust to the rapid appreciation of the Canadian dollar. This also translates into a difficult regional split, where Alberta is overheated and central Canada verges on recession.
  - Third, the answer is productivity. That's why after years in the wilderness, the issue has become topical. There is a growing public understanding that the only way to maintain the 3% growth rate needed to sustain us in the style to which we have become accustomed and the style we will need as the population ages, is through increasing output relative to input, or "working smarter". By the way, that is also the route to environmentally sustainable growth, but that's a whole other speech.
- Unfortunately, politicians don't like the P word. And I expect that the Finance Minister's statement in a few weeks will confine productivity to the tables and charts and talk about prosperity or wealth creation.
- **But the bottom line is that we have taken the major gains from trade, employment and, more recently, resource prices and there is really nowhere else to turn but productivity improvement.**
- Unfortunately, it's not only that politicians don't like to talk about it, it's also hard to do. Canada's productivity performance improved from about 1997-2002 after a dismal record over the previous 20 years but has since then been relatively poor again, particularly compared to some of our major competitors like the United States.
- In fact, on most factors that improve productivity performance, capital investment (including ICTs), R&D and new product innovation, human resources – we have a longstanding track record of mediocrity by international standards.

- This is all the more urgent because of our exchange rate which requires us to become much more productive just to stay in the game in both export and domestic markets.
- We should not count on a decline in the value of the Canadian dollar to save our exporters as it did in the nineties. Even with some softening of resource prices, the dollar may stay uncomfortably high for many exporters, as what's also going on is a decline in the value of the American dollar against most currencies.
- The good news for those companies that weather the storm is that they are forced to become much more productive and will be more competitive in the longer term.
- Indeed, there is a great opportunity now to reinvest in much needed machinery and equipment, most of it imported at lower prices than in the past. That's a huge productivity driver, but our track record is poor, at roughly 60% of US investment relative to GDP.
- I have more good news for many of you in this room. A recent study by the Royal Bank showed that smaller firms were increasing their productivity performance by 2.5-3.0% annually (by the way, that's a fabulous result) compared to an anaemic half per cent rate of increase among large firms.
- Just to put a point on it, with a 2.5% productivity rate, enjoyed by the US, wealth doubles in 28 years while at our current rate of 1.5% it takes 47 years. That's indicative of the potential disparity in living standards between Canada and the US down the road, and we are starting with about a 15% gap in overall productivity today.
- You may be sceptical about all this. After all, we are a prosperous country and our economic performance has been pretty good. But the real issue is whether we will continue to meet the challenge on a go forward basis.
- Not everyone is convinced about our future direction. For example, the World Economic Forum which assesses the competitiveness of some hundred countries on a broad range of quantitative and qualitative criteria, ranked Canada 16th overall this year, well behind the US (6), Japan (7), but still ahead of China (54). That sounds okay, but we were as high as 4th place in the late nineties and have been sliding ever since.
- Another measure of our competitiveness if Foreign direct investment (FDI). Well, here the story is one of similar decline over the last decade. Remember the promise of the FTA and subsequently NAFTA that Canada would be the location of choice for investment in North America?
- The reality is that we have gone from about a 12% share in NA inward investment to 6%. And at that, the investment is heavily skewed towards the resource sectors, particularly energy, where the stuff is in the ground.
- Canadian business people don't, however, miss out on opportunities. During this same period Canadian investment abroad soared, and we know have a substantially greater stock of investment abroad than foreigners do in Canada.
- So what do we need to do about improving our performance? And how should government policies assist that? In my view, there are four priorities:

    1. increasing the share of investment in machinery and equipment to GDP;

2. investing more heavily in the quality of the labour force;
3. shifting focus from cost-driven productivity improvement to quality-driven improvement or innovation; and finally,
4. becoming more attractive to FDI generally, and specifically in key sectors.

- Let me now touch on each of these and provide the Finance Minister with some policy prescriptions.
- First, M&E investment. We are dramatically lower than most competitors, partly because until recently labour was relatively cheap compared to capital.
- One area within that where there is huge room for improvement is ICTs. ICTs are important because they have been shown to be a major driver of productivity improvement for all businesses. In fact, studies have estimated ICTs to be responsible for about 60% of the recent boom in the US.
- And where are we? We are investing at about 2/3 the rate of the world leader, the US, and behind the Nordic countries, Australia, the UK and Benelux.
- What to do? This is one area where it mainly comes down to taxes. Tax business less, so that they can invest more. It also puts a perspective on the income trust debate and the concern that a trust structured business sector would in fact invest less.
- Second, the quality of the labour force. Virtually all new, permanent jobs require post secondary education in our increasingly knowledge-based economy.
- The exception at the moment is the overheated Alberta economy where there is concern that young people are leaving school to take on work in the resource and services sectors.
- Although Canada has high enrolment in post-secondary education we have been underinvesting in education relative to other countries and relative to where we were 20 years ago. Why? Health care, which is sucking up all available funds among provincial governments.
- The bottom line is that I don't think there is a lot structurally unsound in our education system, but to invest adequately we need first to fix health care and that is not happening fast enough.
- The second key element of improving the labour force is immigration, the only source of net increase in the labour force in the years ahead. Although Canada is increasingly accepting skilled immigrants in its mix, we are doing badly at ensuring that those skills are translated into meaningful opportunities.
- There are many issues to fix here, ranging from credential recognition to transitional support. This is the work of both federal and provincial governments.
- Third, innovation. Canadians have been pretty good at adopting and adapting process technologies. What we are not very good at by international standards is product innovation, being the first out there with a world-beating product and staying ahead of the game. We just don't have enough products like the Blackberry.

- What to do is difficult to prescribe. After all, this is a private sector issue, with thousands of business people making thousands of strategy decisions, for better or worse.
- Arguably, the best role for government is to stay out of the way or remove obstacles to business dynamism.
- Many of these unfortunately are regulatory. I say unfortunately because regulatory reform has never been a political priority. How do you get a sound-byte out of intellectual property legislation? I use this example having spent seven frustrating years trying to move forward on this and other business regulation issues to bring them into the 21st century.
- Finally, making Canada more attractive to FDI. As I said earlier, we are losing ground not just to the US, but more recently to emerging economies like India and China.
- What to do? Well, first, be more aggressive internationally because its no longer about just attracting investment to Canada, its about building global business networks with a substantial Canadian component, either as owners or partners.
- That is largely a business challenge, but government can do one important thing and that is to open closed Canadian markets to foreign investment, not only to attract capital but also with it global management expertise and innovative capacity.
- So what markets am I talking about? Transportation, telecommunications, banking – those sectors that are enablers for the rest of the economy where non-Canadians are still heavily restricted. Unfortunately, again politicians are loath to go global for the 21st century because of the certainty of mid 20th century nationalistic debates.
- I should also point out that increased public investment in education (item 2 on my list) is probably the single best initiative to attract FDI.
- With labour as the least mobile factor of investment compared to capital and technology, investment will come to where the labour force quality is high. I know this sounds like a field of dreams – build it and they will come.
- If you think I have all this wrong, look at Ireland whose GDP per capita was about 75% of Canada's 20 years ago and is now actually higher. After joining the EU (the equivalent to our NAFTA) what the Irish did was lower business taxes, invest in education, and aggressively attract FDI. It's almost that simple.
- Thank you very much for inviting me, and I look forward to questions.

Andrei Sulzenko

November 14, 2006