Impressions of Canada's Economic Future

by R. D. Fullerton

INTRODUCTION

The CIBC has continued to perform well and remain financially healthy in the midst of a very weak and ailing domestic economy. Moreover, our return on equity over the past 10 years, including last year, is well within the boundaries of what other businesses and industries consider healthy. I would hope you share my belief that our performance has been balanced, even in troubled times, and has helped contribute to the strength of, and confidence in Canada's financial system.

I'd like to offer a series of impressions which I have formed over the years and expressed in a number of speeches across Canada.

My impressions are about some of the more contentious economic issues facing Canada at this moment and the unfortunate way many Canadians are reacting to them.

Specifically, I'm talking about the controversy and misunderstanding that frequently surrounds important issues like exchange rates, monetary policy and the high levels of debt and deficit this country is now burdened with.

Many of the impressions I'd like to share with you today are based on two principles.

The first principle is that the most obvious, popular or immediate solution to any economic problem is very often the wrong solution. It's wrong because it is frequently shaped by partial, limited and sometimes self-serving interpretations. Furthermore, these interpretations tend to ignore complexity and disregard the complete context in which that solution must operate.

And the second principal is simply that solutions which may have worked in the past do not necessarily work in the present.

These are neither profound nor complicated propositions. But you'd be surprised how often they are shoved aside or forgotten by informed and well-intentioned people.

CURRENT ECONOMIC CLIMATE

Consider the current economic climate. Like most Canadians, I'm deeply concerned about the depressed economic conditions in Canada today.

Canada is experiencing the effects of a recession which has turned out to be far more protracted and painful than many people initially imagined.

Personal bankruptcies in the first nine months of 1992 were 42,000.

The human cost is even more disturbing. Statistics Canada reported that total employment in Canada's manufacturing sector in October 1992 stood at 1,761,000 - its lowest point since the end of the last recession in the early 1980s.

In effect, virtually all the job gains made in that sector since our emergence from the last recession have been wiped out.

What's particularly distressing is that many of the jobs lost in this recession are not going to reappear once we're into a recovery.

As for unemployment . . . for the past 11 months the unemployment rate in Canada has been over the 10 per cent mark, with more than 1.5 million people out of work. And forecasts suggest little improvement in the situation for 1993.

That 1.5 million figure, by the way, does not include those individuals who have despaired of finding jobs altogether. As of late last year, there were over 2.2 million Canadians receiving social assistance from provincial and municipal governments.

All told, then there are now at least 3.4 million jobless men and women in this

R. Donald Fullerton

R. Donald Fullerton is the retired chairman and chief executive officer, and currently serving as the chairman of the executive committee, of the CIBC group of companies, one of the largest financial services institutions in North America.

Born June 1931 in Vancouver, B.C., Mr. Fullerton joined the Canadian Bank of Commerce (now CIBC) in Vancouver in 1953. After serving in a number of progressively responsible positions, he was appointed manager, Regina, and in 1967, the regional general manager, international. In 1968, he was appointed deputy chief general manager.

In 1971, he became senior vice-president, and in 1973, he was promoted to executive vice-president and chief general manager. In the following year, he was appointed president and chief operating officer. In 1984, he became chief executive officer and in 1985, he was named chairman. He retired as chairman and chief executive officer in June 1992.

Mr. Fullerton earned his B.A. degree from the University of Toronto in 1953. He is a director of Amoco Canada Petroleum Co. Ltd.; Coca-Cola Beverages Ltd.; Gendis Inc.; Hollinger Inc.; Honeywell Inc.; IBM Canada Ltd.; George Weston Ltd. and the Wellesley Hospital in Toronto.

country.

Even the prospect of economic recovery is disappointing. The Organization for Economic Co-operation and Development expects Canada's growth rate for 1992 to be about 1.5 %. That's well below what many consider normal for the first year of a recovery. At CIBC, we consider even that prediction optimistic and have forecast growth in the area of 1.4 % for 1992.

Clearly, then, this has been a very tough recession.

Worse, it has also been a very atypical one, in the same sense that there seems little we can do to moderate its negative effects - which brings me to my point about solutions.

Traditional solutions like spending our way to recovery are no longer as easily implemented or as practical as they have been in the past.

Other conventional responses, such as dramatically lowering interest rates and substantially devaluing the dollar carry with them long-term drawbacks as well. And even if we could readily adopt these measures, there is no guarantee that they could replace lost jobs - certainly not the same jobs. That's partially because many of those lost jobs demanded few of the skills a modern society must develop in its workforce if it expects to competitive and prosperous.

The jobs that matter today are ones that require at least some post secondary education. They also demand literacy, a high degree of technological knowledge, strong analytical and problem-solving skills, and the ability to understand complex technical information and to communicate that information effectively to others.

The traditional stimuli once employed to recover from recession and its aftermath - along with the results those stimuli are expected to deliver - have lost much of their potency and reliability. The reasons for this will grow progressively clearer to people the longer it takes, and the more frustrating it becomes, for us to drag ourselves out of the present economic quagmire.

First, the fiscal and monetary solutions often used in the past to stimulate growth during hard times - lower interest rates, increased public spending, and so forth - have had their effectiveness significantly compromised by the huge debts and deficits built up by all levels of government.

And second, what's also compounding the problem of recovery is the fact that Canada is moving far too slowly in making the adjustments essential to being a serious competitor in the global marketplace - adjustments in which other nations have made significant headway.

FISCAL AND MONETARY SOLUTIONS

Our debt and deficits have hamstrung the ability of governments to alleviate economic hardship and rekindle economic activity. At present the combined debt of federal, provincial and municipal governments in this country is around $760 billion. Our federal debt alone is around $423 billion, making Canada's debt-to-GDP ratio among the worst in the industrialized world and twice that of the United States.

What's more, at least 22 per cent of that national debt is held by foreign investors, double the percentage they held in 1980.

This limits a government's capacity to ease economic pain, because the measures that may stimulate a domestic economy may be precisely the measures that scare international investors away. And our huge debt load cannot, unfortunately, be financed without offshore money.

For instance, the cry goes out, as it did last year and the year before, to lower interest rates and thereby stimulate investment and growth. A proven solution . . . for an earlier, less debt-ridden era. But today, we have to exercise great care in employing such measures. The moment we significantly and unilaterally lower our interest rates, particularly in relation to those of the U.S., the foreign investors we need just to pay the interest charges on our debt could start looking elsewhere for more attractive rates. As a result, Canada's ability to finance its debt is jeopardized and with it its credit standing in the international financial community. And I defy any modern, debtor economy to try to function effectively without the trust and financing powers of that community.

The same thing is true for devaluation - an option favored by many because it would make Canadian exports more competitive in world markets. Should the Bank of Canada suddenly slash interest rates further - an action which would tend to significantly reduce the value of the Canadian dollar - you'd most likely get the following reaction.

Those investors who had bought government bonds - issued to finance our debt - when the dollar was at 86 or 87 cents (U.S.) would sharply curtail, stop or even sell off their purchases. Concern over inflation, fear of possible further depreciation of the dollar and the desire to find more stable investment opportunities would be the main reasons for their actions.

As experience has taught us, it's not only foreign investors who react this way. Domestic investors, as well, often cash in and place their funds in countries which they believe to be more stable and offer more attractive interest rates. Capital flight, in other words - a practice which we used to think was confined only to certain Latin American countries.

So we're back to the same old problem - concern over our future ability to finance our debt and the threat of a loss of confidence on the part of the investment community, both foreign and domestic.

As for increased public spending - another traditional anti-recession weapon - any increase there could trigger renewed inflation, especially if that spending is funded by substantial increases in taxes and, in particular, indirect taxes.

Canada currently enjoys enormous stature among foreign investors thanks to the inflation-fighting policies of John Crow, governor of the Bank of Canada. A massive spending increase on the part of governments would seriously undermine those policies and could possibly force the Bank to raise interest rates to control inflationary pressures. This, of course, would hamper the very objective governments were trying to achieve - economic recovery.

On the other hand, should the Bank of Canada choose to support these fiscal measures and not raise interest rates, foreign investors could conclude that the Bank had retreated from its anti-inflation investment in Canadian bonds. As a result, we'd be back once more to the problem of an international lack of confidence in Canada's credit-worthiness and to the necessity of raising interest rates to attract investors.

Debt. Debt. Debt. You can see how it frustrates our ability to deal effectively with the effects of recession.

That does not mean that all the old truths are without some merit.

For example, a lower Canadian dollar does have its benefits, such as making our exports more competitive. But if we want those benefits to be long-lasting ones, then it's up to business and industry to make them so.

Should the private sector rely solely on a lower dollar to make its products more competitive in global markets, then a lower dollar is a bogus option.

For example, if the rest of the world is boosting productivity, lowering manufacturing costs and investing heavily in technology to produce sophisticated, value-added products and services - and all we're doing is relying on a lower dollar - then eventually we're going to have to lower that dollar again, and again, and again just to keep pace. That means Canadian business will be competing mainly on price rather than through innovation, quality and value. Furthermore, it will be doing so under the inevitable and undesirable condition of roughly a 0.3 per cent increase in inflation for every one cent reduction in the exchange rate.

On the other hand, a decline in the value of the dollar can provide some lasting business benefits. But that's only if Canadian firms take the increased profits that a lower Canadian dollar can deliver and put those profits back into their companies in the form of new machinery, new processes, improved delivery mechanisms, better training and service, and ultimately enhanced competitiveness.

Otherwise, as I said before, it's a bogus option.

PRODUCTIVITY KEY TO GROWTH

And that brings me to the second reason why the effects of this recession have been so difficult to combat. And that's simply that Canada will never fully emerge from its current economic malaise without making a commitment to improve its productivity and its overall competitive posture in the world. But that's going to involve some significant long-term adjustments on our part.

I've already suggested that in order to have a competitive economy we need to train and develop a highly skilled workforce. As of 1988, however, Canada's private sector provided on average only about seven hours of in-house training for its workers, whereas in Sweden the average worker received 170 hours of training and in Japan the figure was 200 hours. Even now - four years later - few Canadian firms provide funds for formal training for their workers.

But training is just one of many competitive challenges Canada needs to address. There's also the matter of our poor productivity growth, for example. Productivity measures a nation's output obtained from each hour of labor or each dollar of capital. Since 1985, Canada's productivity growth has lagged behind that of every other G-7 country. In the U.S. alone, manufacturing productivity was 34 per cent higher in 1989 than it was in Canada. And the U.S., in turn, is worried about Japan.

Unit-labor costs, on the other hand, have risen dramatically over the same period while they actually declined in the U.S. and in Japan. What's more, it's been estimated that only about 40 per cent of the increase in our unit-labor costs has been because of a high Canadian dollar. That suggests to me that a lower dollar must be accompanied by a host of efficiency and productivity improvements if it is to have its desired long-term effect.

Then there's the whole problem of Canada's low levels of research and development. Canada's record here is among the least enviable in the industrialized world. In 1990, Canada spent just 1.3 per cent of its GDP on research and development. Next to Italy, that was the lowest ratio of any major Western nation.

Education represents another competitive challenge. According to the federal governments's recently published report on prosperity, "over half of the new jobs in this decade will require more than 12 years of education and training, yet some 60 per cent of today's workforce possesses no more than a high school education."

That predicament is compounded by high levels of adult illiteracy, above-average school drop-out rates relative to other countries and an alarming shortage of professional research scientists and engineers. The National Advisory Board on Science and Technology, for example, projects a shortfall of 10,000 engineers alone by the end of the decade.

A poor track-record in training, low productivity, high unit-labor costs, weak R&D performance, problems in education and a distressing shortage of engineers and skilled researchers. These are just a few of the competitive challenges we have to cope with if we want to avoid a repeat of what's happening in our economy right now - permanent job loss, high unemployment and slow growth due to our inability, reluctance or slowness to provide the value-added goods and services that world markets want, need and are willing to pay for.

BUILD ON EXISTING STRENGTHS

But as we are addressing these challenges, let's also make sure that we continue to exploit and build on our existing strengths. Canada still enjoys, for instance, a comparative advantage in world trade thanks to its rich and diverse resource sector.

It would be the height of folly if, in our urge to develop a more competitive manufacturing base, we neglected to make similar adjustments in our resource sector. In economic terms, Canada's resource industry remains one of the best things we have going for us.

Here is a sector that in 1991, in forest and mining products alone, accounted for a trade surplus of approximately $28 billion that helped offset a trade deficit that same year of almost $21 billion in all other elements of our merchandise trade.

To maintain the advantage our resource base gives us in world trade - and to match the efforts of our international rivals in this area - it is absolutely essential that we direct an equal amount of energy toward developing more value-added commodity products and toward devising more efficient processes to produce and market those products worldwide.

If we don't adopt this strategy, and marry it to a similar strategy of improving our manufacturing capability, then our current economic woes will continue if not grow worse.

No, the old solutions to recession and recovery do not work as well as they used to. Nor are there any simple remedies to the complex economic problems we now face.

The only effective, long-term solutions today are the ones that acknowledge complexity, admit the restraining influence of debt and deficit, recognize the need for fiscal restraint on the part of all governments and embrace a commitment to enhance national competitiveness.

CONCLUSIONS

I realize we are now in exceptional and trying circumstances. Unemployment is high. Our welfare rolls are growing daily. And millions of Canadians are experiencing acute economic hardship and the personal anxiety that goes with it.

Now is not the time to advocate deep cuts in government deficits or a radical decrease in public spending. It is going to be tough enough just to maintain the status quo for the next year. The alleviation of individual hardship, certainly when it assumes the proportions it currently has, must take priority.

My only suggestion is that governments, in implementing the measures needed to light economic pain, make sure that those who need assistance the most get it.

That means establishing specific criteria and setting priorities which enable our already stretched financial resources to go where they can do the most good. It does not mean indiscriminate and undisciplined largesse.

I want to emphasize, as well, that these are only stop-gap measures. More spending or a suspension of effort in fighting debt and deficits will not overcome the structural barriers to long-term success and prosperity.

Those barriers can only be surmounted by sustained fiscal responsibility and the resolve to improve our national competitive position.

In the past, we have sadly neglected both these imperatives. During the economic boom of the 1980s, in particular, we blew a golden opportunity to substantially lower deficits. And we're paying for it.

Let us resolve now, even as we struggle to emerge from our present economic troubles, that we will never let such an opportunity slip by us again.

Simplistic solutions to complex problems rarely work.

And no solution, no matter how effective it may once have been, stays effective forever.